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IN THE

Supreme Court of the United States.

OCTOBER TERM, 1920.

No. 609

ELDORADO COAL AND MINING COMPANY,
Plaintiff in Error,

vs.

HARRY W. MAGER, COLLECTOR OF INTERNAL REVENUE FOR THE FIRST DISTRICT OF ILLINOIS,
Defendant in Error.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION.

BRIEF AND ARGUMENT FOR PLAINTIFF IN ERROR.

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IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION.

BRIEF AND ARGUMENT FOR PLAINTIFF IN ERROR.

STATEMENT OF THE CASE.

The suit.

This is a suit in assumpsit brought in the District Court of the United States for the Northern District of Illinois, Eastern Division, by the Eldorado Coal and Mining Company against Harry W. Mager, as collector of internal revenue at Chicago, Illinois. The first count of the declaration seeks the recovery of $1,706.34, paid under protest on account of income and excess profits taxes assessed, under the alleged authority of the Reve-

nue Acts of 1916 and 1917, on part of the proceeds of a winding-up sale, in May, 1917, of the capital assets of the company. The second count seeks to recover $1,366.82, the amount of an additional portion of such taxes, in payment of which there was applied, without the company's consent, the sum of $1,366.82, admittedly due and owing to the company as a refund of an overpayment of income and excess profits taxes for an earlier taxable period. The collector filed a general demurrer which was sustained by the district judge, who thereupon dismissed the suit. The case comes up to this court on a writ of error direct to the District Court.

The contentions.

The taxes in question were based on the theory of the Treasury Department that the proceeds of the winding-up sale of the company's assets, to the extent that such proceeds were in excess of the March 1, 1913, value (properly adjusted to date of sale for additions, betterments, depreciation, and depletion) of the assets so sold, constituted income to the company taxable under the income tax provisions of the Revenue Acts of 1916 and 1917 and under the excess profits tax provisions of the Revenue Act of 1917. The company contended in its declaration, and still contends: (1) that said taxes were in violation of Article I, Section 2, Clause 3, and Article I, Section 9, Clause 4, of the Constitution of the United States, in that said taxes were not apportioned in accordance with those provisions of the Constitution, and yet were not excise taxes, nor taxes on income within the meaning of the Sixteenth Amendment; (2) that said taxes were invalid in that such excess did not in any event constitute income to the company; and (3) that said taxes were in-

valid in that they were not authorized by the Revenue Acts of 1916 and 1917.

The Eldorado Company and its business.

The plaintiff in error, Eldorado Coal and Mining Company, is an Indiana corporation. For many years prior to May, 1917, it owned and operated a bituminous coal mine and coal mining plant situated near the City of Eldorado, Saline County, Illinois. The only business in which it was ever engaged consisted wholly of mining coal from this mine and of shipping and selling such coal. (Rec., 2.)

Winding-up sale.

Early in the year 1917, the stockholders decided to give up business and to distribute the capital assets of the company among themselves as such stockholders. In May, 1917, therefore, the coal mine and coal mining plant, in fact, all of the assets of the company, except some accounts receivable and its books of account, were sold for the sum of $275,000 in cash, nearly all of its capital assets being thus converted into the form of money. The company thereupon ceased business, and prior to September 30, 1917, it closed up its affairs by distributing all of said accounts receivable or the proceeds thereof, and all of the proceeds of the sale of its capital assets, among its stockholders in proportion to their holdings of stock. The only reason that the company did not also dissolve and surrender its charter was the belief of its directors that it ought to remain in existence until its liability for federal income and excess profits taxes should have been definitely and finally determined. (Rec., 2.)

Filing of returns.

After this sale and distribution, the company, in order to comply with the provisions of the Revenue Acts of 1916 and 1917, filed in due course its income and excess profits tax returns for the fiscal period beginning April 1, 1917, and ending September 30, 1917. These returns did not include in the gross income of the company any part of the $275,000 received in payment for the capital assets. The amount shown due by these returns was duly paid by the company. (Rec., 2-3.)

Audit and "assessment letter."

Several years later the Bureau of Internal Revenue audited the books and records of the company and its returns for the fiscal period ending March 31, 1917, and the fiscal period beginning April 1, 1917 and ending September 30, 1917. As a result of that audit, on January 7, 1920, a so-called assessment letter was sent to the company on behalf of the Commissioner of Internal Revenue. This letter admitted that the United States was indebted to the company in the sum of $1,366.82, on account of an overpayment of that amount made by the company in paying its income and excess profits taxes for the fiscal period ending March 31, 1917. It also announced that the commissioner was going to assess against the company additional income and profits taxes for the fiscal period beginning April 1, 1917, and ending September 30, 1917, and was going to set off against these additional taxes said admitted indebtedness to the company of $1,366.82. These additional taxes were based, as shown by the letter, on the conclusion of the commissioner that a taxable profit had been realized by the company, by the conversion into money, on said wind-

ing-up sale, of the capital assets so invested and employed in its business. (Rec., 3.)

The appreciation in value of the assets.

By taking the fair market value as of March 1, 1913, of the capital assets so invested and employed in the company's business, adding the cost of additions and betterments, subtracting depreciation and depletion to the date of sale, and using the resulting amount as a basis, it appears that $5,986.02 of said sale price of $275,000 represented an appreciation since March 1, 1913, in the money value of the company's coal mine and coal mining plant, which, as already stated, constituted by far the greatest part of its capital assets so invested and employed in its business. This appreciation of $5,986.02 in money value was converted by the sale into $5,986.02 in money. (Rec., 3.)

Additional assessment.

On or about February 10, 1920, the commissioner assessed against the company, in accordance with the assessment letter, additional income and excess profits taxes for the fiscal period beginning April 1, 1917, and ending September 30, 1917. That part of the taxes so assessed which was based on the appreciation of $5,986.02 in the money value of the coal mine and the coal mining plant amounted to $3,073.16. In making this additional assessment the commissioner, in accordance with the assessment letter, applied the admitted indebtedness of the government to the company of $1,366.82, to the partial payment of said tax of $3,073.16, leaving of said $3,073.16 a balance of $1,706.34 subject to demand by the Collector of Internal Revenue at Chicago, Illinois. (Rec., 3-4.)

Demand for additional taxes.

On March 3, 1920, the defendant in error, Harry W. Mager, as Collector of Internal Revenue at Chicago, Illinois, served on the company a written "notice and demand for tax," thereby demanding the payment by the company, on or before March 10, 1920, of additional income and excess profits taxes for the fiscal period beginning April 1, 1917, and ending September 30, 1917. The taxes so demanded were the additional taxes so assessed on February 10, 1920, and included the aforesaid additional tax of $1,706.34. (Rec., 4.)

Payment under protest.

On March 10, 1920, the company, solely to avoid the threatened penalties, paid to the defendant in error, as such collector, the sum of $1,706.34 so assessed against and demanded from it. This payment was made under protest, on the ground that this additional tax of $1,706.34 was illegal, unconstitutional and void for the reasons fully developed hereafter in our brief and argument. (Rec., 4.)

Claim for refund made and denied.

On April 10, 1920, the company filed with the defendant in error, as such collector, for transmission to the commissioner, an appeal and application for the refund of the sum of $1,706.34 (so assessed and paid under protest) in manner and form as provided in Sections 3226, 3226 and 3228 of the Revised Statutes of the United States, the other provisions of law in that regard, and the regulations of the Treasury Department. This appeal and application for refund also demanded the refund to the company of the sum of $1,266.82 so admittedly due by the government to the company and so set off against

$1,366.92 of said additional income and profits taxes, which the company alleges to be illegal, unconstitutional and void. This appeal and application for refund was rejected and denied in toto by the commissioner, on June 25, 1938. (Rec., p. 7.)

Proceedings in the District Court

The company then, having used every possible means for securing the refund of these amounts from the Commissioner of Internal Revenue, filed its declaration in this case against the defendant in error, Harry W. Magee, as such collector, on July 13, 1938. The United States District Attorney at Chicago, in behalf of the defendant in error, filed a general demurrer to the declaration. When the demurrer came on to be heard, on October 27, 1938, the Honorable George T. Page, district judge, holding United States District Court for the Northern District of Illinois, Eastern Division, by assignment, sustained the demurrer and, as the company elected by its declaration, entered a judgment dismissing the suit. A writ of error from this court was thereupon sued out and perfected. (Rec., p. 2.)

Proceedings in this court

The case was docketed in this court on December 5, 1938, as No. 660 of the October Term, 1938. On December 5, 1938, the Solicitor General moved that this case, together with Macheca Iron and Steel Company v. Hinrichsen, No. 659, be advanced and set for argument on January 2, 1939, and this motion was granted by the court, on December 12, 1938.

SPECIFICATION OF ERRORS.

The Eldorado Coal & Mining Company, plaintiff in error, relies in this court on the following errors previously assigned by it:

1. The District Court erred in sustaining the demurrer to the declaration.

2. The District Court erred in not overruling the demurrer to the declaration.

3. The District Court erred in sustaining the demurrer to the first count of the declaration.

4. The District Court erred in not overruling the demurrer to the first count of the declaration.

5. The District Court erred in sustaining the demurrer to the second count of the declaration.

6. The District Court erred in not overruling the demurrer to the second count of the declaration.

7. The District Court erred in directing that final judgment should be entered in favor of the defendant.

POINTS AND AUTHORITIES.

I.

THE WINDING-UP SALE OF ALL THE PROPERTY OF THE ELDORADO COMPANY WAS MERELY A TRANSFORMATION OF CAPITAL, AND NOT A SALE MADE IN THE COURSE OF BUSINESS, AND THEREFORE THE PROCEEDS WERE IN NO PART INCOME WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT, BUT WERE WHOLLY CAPITAL, NOT CONSTITUTIONALLY TAXABLE UNDER THE INCOME TAX PROVISIONS OF THE REVENUE ACTS OF 1916 AND 1917, OR UNDER THE EXCESS PROFITS TAX PROVISIONS OF THE REVENUE ACT OF 1917.

(For Argument, see pages 19-65, *infra.*)

A. THE PROCEEDS OF THE SALE BY THE ELDORADO COMPANY WOULD BE CONSTITUTIONALLY TAXABLE UNDER THE INCOME TAX PROVISIONS OF THE REVENUE ACTS OF 1916 AND 1917, AND THE EXCESS PROFITS TAX PROVISIONS OF THE REVENUE ACT OF 1917, ONLY TO THE EXTENT IF ANY THAT SUCH PROCEEDS WERE INCOME WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT.

(For Argument, see pages 19-26, *infra.*)

REVENUE ACT OF 1916:

Title I, Part II, Section 10, first paragraph, as amended by Section 1206 of Revenue Act of 1917—40 Stat. 333.

Title I, Part I, Section 2 (a), as amended by Section 1200 of Revenue Act of 1917—40 Stat. 329.

Title I, Part II, Section 10, third paragraph—39 Stat. 766.

REVENUE ACT OF 1917:
Title I, Section 4—40 Stat. 302.
Title II, Sections 201 and 206—40 Stat. 303, 305.

UNITED STATES CONSTITUTION:
Article I, Section 2, Clause 3.
Article I, Section 9, Clause 4.
Sixteenth Amendment.

Pollock v. *Farmers' Loan & Trust Co.* 157 U. S. 429; 158 U. S. 601.

B. THE PROCEEDS OF THE SALE BY THE ELDORADO COMPANY WERE WHOLLY CAPITAL—IN NO PART INCOME WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT.

(For Argument, see pages 26-65, *infra.*)

1. *There is a fundamental difference between a profit realized on a sale by a merchant or trader in the course of his business and a gain resulting from an increase in a capital investment; income arises on the sale in the case of the merchant, but, in the case of the capital investment, income arises neither on the sale nor prior thereto.*

(For Argument, see pages 26-32, *infra.*)

Hudson's Bay Co. Ltd. v. *Stevens,* 5 Tax Cases, 424, 437.

Assets Company, Ltd. v. *Forbes,* 3 Tax Cases, 542, 548.

Ex Parte Humbird, 114 Md. 627, 633.

2. *This court has decided that, in the case of a merchant in the course of his business, income accrues and is received when he sells for a profit, but that, in the case of an investor, income does not accrue and is not received while his capital investment is increasing in value, nor when the investment is sold.*

(For Argument, see pages 32-39, *infra.*)

Gray v. *Darlington,* 15 Wall. 63, 65-66.

Lynch v. *Turrish,* 247 U. S. 221, 229-230.

Eisner v. *Macomber,* 252 U. S. 189, 207, 214-215.

See, also:

Brewster v. *Walsh,* U. S. Dist. Ct., Conn., Dec. 16, 1920—unreported, but printed opinion to be furnished to this court.

3. *Cases decided by this court under the Corporation Excise Tax Act of* 1909 *are not inconsistent with the decisions of this court previously cited.*

(For Argument, see pages 39-45, *infra.*)

Stratton's Independence, Ltd. v. *Howbert,* 231 U. S. 399, 414.

Flint v. *Stone Tracy Co.* 220 U. S. 107.

Doyle v. *Mitchell Brothers Co.* 247 U. S. 179, 181, 183, 187.

Von Baumbach v. *Sargent Land Co.* 242 U. S. 503, 521.

Hays v. *Gauley Mountain Coal Co.* 247 U. S. 189, 193.

United States of America v. *C. C. C. & St. L. Ry. Co.* 247 U. S. 195.

4. *If increase in the value of an investment accrues as income during the period of such increase, it cannot become income only when the investment is sold; and if increase in the value of an investment is capital, and never, even on a sale of the investment, accrues as income, the increase in value can never be received as income.*

(For Argument, see pages 46-50, *infra.*)

Lynch v. *Turrish*, 247 U. S. 221, 229.

Gray v. *Darlington*, 15 Wall. 63.

5. *An increase in the money value of capital is not realized as income by a sale or conversion of the capital.*

(For Argument, see pages 50-58, *infra.*)

The idea that income is realized by conversion of capital which has increased in value is evidently due to a confusion of ideas in two particulars: *first*, the fact that a merchant or trader realizes income only when he *sells* the property in which he trades suggests the idea that any sale, when increase in value has already occurred, must likewise produce income; *second*, it has been assumed that an accounting practice in recording capital values was based on a distinction between capital and income, when in fact it is not.

6. *Prior to the adoption of the Sixteenth Amendment both English and American courts had definitely decided that the sale of capital investments at an advance over cost did not produce income.*

(For Argument, see pages 58-65, *infra.*)

English Cases:

Northern Assurance Co. v. *Russell* (1889), 2 Tax Cases, 577.

Scottish Investment Trust Co. v. *Forbes* (1897), 3 T. C. 231; 31 Scot. Law Reporter, 219.

Assets Co. Ltd. v. *Forbes* (1897), 3 T. C. 542; 34 Scot. Law Reporter, 486.

Californian Copper Syndicate v. *Harris* (1904), 5 T. C. 159, 166; 6 F. 894.

Hudson's Bay Co. v. *Stevens* (1909), 5 T. C. 424; 25 T. L. R. 709.

Tebrau Rubber Syndicate, Ltd. v. *Farmer* (1909), 5 T. C. 658; 47 Scot. Law Reporter, 816.

American Cases:

Gray v. *Darlington*, 15 Wall. 63.

Re Gerry, 103 N. Y. 445.

Van Vleck v. *Lounsbery*, 34 Hun, 569.

Patterson v. *Vivian*, 122 N. Y. Supp. 347.

Furniss v. *Cruikshank*, 181 N. Y. Supp. 522.

Graham's Estate, 198 Pa. 216.

Neel's Estate, 207 Pa. 446.

Hubley's Estate, 16 Phil. 327.

Outcalt v. *Appleby*, 36 N. J. Eq. 73.

Devenney v. *Devenney*, 74 Ohio St. 96.

Ex parte Humbird, 114 Md. 627.

Jordan v. *Trust Estate of Jordan*, 111 Maine, 124.

Bank v. *Lee*, 66 S. W. (Ky.), 413.

Coleman v. *Grimes*, 110 S. W. (Ky.), 349.

Bank v. *Mulholland*, 85 So. (Miss.), 111.

See, also:

Tax Comr. v. *Putnam*, 227 Mass. 522, 527-528.

Brewster v. *Walsh*, U. S. Dist. Ct. Conn. Dec. 16, 1920—unreported, but printed opinion to be furnished to this court.

II.

THE WINDING-UP SALE BY THE ELDORADO COMPANY WAS A CONVERSION OF THE CAPITAL OF ITS STOCKHOLDERS AND DID NOT INVOLVE A REALIZATION OF INCOME TO THE CORPORATION, EVEN IF INCOME CAN EVER ARISE FROM THE CONVERSION OF A CAPITAL INVESTMENT WHICH HAS INCREASED IN VALUE.

(For Argument, see pages 65-74, *infra*.)

A. A WINDING-UP SALE DOES NOT INVOLVE A CONVERSION OF TWO INVESTMENTS, ONE AN INVESTMENT OF THE CORPORATION AND ANOTHER AN INVESTMENT OF THE STOCKHOLDERS.

(For Argument, see pages 65-71, *infra*.)

B. THE AUTHORITIES SUSTAIN THE CONTENTION THAT ON A WINDING-UP SALE BY A CORPORATION THE INVESTMENT SOLD IS THE INVESTMENT OF THE STOCKHOLDERS, AND THAT ANY PRIOR INCREASE IN THE VALUE OF THE PROPERTY SOLD WAS AN INCREASE IN THE VALUE OF THEIR INVESTMENT.

(For Argument, see pages 72-74, *infra*.)

Lynch v. *Turrish*, 247 U. S. 221, 228.

Collector v. *Hubbard*, 12 Wall. 1.

Bailey v. *Railroad Co.* 22 Wall. 604, 635, 636.

Tebrau Rubber Syndicate, Ltd. v. *Farmer* (1909), 5 Tax Cases, 658; 47 Scot. Law Reporter, 816.

III.

NEITHER THE INCOME TAX PROVISIONS OF THE REVENUE ACTS OF 1916 AND 1917, NOR THE EXCESS PROFITS TAX PROVISIONS OF THE REVENUE ACT OF 1917, IMPOSE ANY TAX ON ANY PORTION OF THE PROCEEDS OF THE ELDORADO WINDING-UP SALE—A MERE TRANSFORMATION OF CAPITAL ASSETS.

(For Argument, see pages 74-85, *infra*.)

A. THIS COURT HAS ALREADY HELD THAT THE INCOME TAX PROVISIONS OF NEITHER THE ACT OF MARCH 2, 1867, NOR THE ACT OF OCTOBER 3, 1913, IMPOSED ANY TAX ON A REALIZED INCREASE IN THE VALUE OF CAPITAL ASSETS, AND THE REVENUE ACTS OF 1916 AND 1917 MUST RECEIVE THE SAME INTERPRETATION.

(For Argument, see pages 74-84, *infra*.)

1. *The income tax provisions of neither the Act of March 2, 1867, nor the Act of October 3, 1913, imposed any tax on a realized increase in the value of capital assets.*

(For Argument, see pages 74-76, *infra*.)

Gray v. *Darlington*, 15 Wall. 63.

Lynch v. *Turrish*, 247 U. S. 221.

See, also:

Maryland Casualty Co. v. *United States*, 251 U. S. 342.

2. *The provisions of the Revenue Acts of 1916 and 1917 which define the property on which the income and excess profits taxes are imposed are substantially the same as the corresponding provisions of the Act of March 2, 1867, and of the Act of October 3, 1913.*

(For Argument, see pages 76-79, *infra*.)

INTERNAL REVENUE ACT OF MARCH 2, 1867:
Section 13, second paragraph—14 Stat. 478.

TARIFF ACT OF OCTOBER 3, 1913:
Section II, B—38 Stat. 167.

REVENUE ACT OF 1916:
Title I, Part I, Section 2 (a), as amended by Section 1200 of Revenue Act of 1917—40 Stat. 329.

3. *It is, of course, well settled that provisions of a statute which are substantially the same as provisions of a prior statute covering the same subject should be given the same construction as those prior provisions, especially where those provisions had been judicially construed.*

(For Argument, see page 79, *infra.*)

The Abbotsford, 98 U. S. 440, 444.
McDonald v. *Hovey*, 110 U. S. 619, 628.
Sessions v. *Romadka*, 145 U. S. 29, 42.
White-Smith Music Publishing Co. v. *Apollo Company*, 209 U. S. 1, 14.

4. *No rulings of the Treasury Department can affect the duty of the court to give the same interpretation, in this respect, to the Revenue Acts of* 1916 *and* 1917 *as to the Act of March* 2, 1867, *and the Act of October* 3, 1913.

(For Argument, see pages 79-81, *infra.*)

5. *Neither the new provisions of the Revenue Act of* 1916 *making the March* 1, 1913, *value the basis for computing gain or loss "from the sale or other disposition" of property, nor the new provision in that act with regard to losses of individuals, serve to make the scope of the Revenue Acts of* 1916 *and* 1917 *any broader, as to realized increases in the value of capital assets, than the Act of March* 2, 1867, *or the Act of October* 3, 1913.

(For Argument, see pages 81-84, *infra.*)

REVENUE ACT OF 1916:

Title I, Part I, Section 2 (c)—39 Stat. 758.

Title I, Part II, Section 10, third paragraph—39 Stat. 766.

Title I, Part I, Section 5 (a), Fourth and Fifth—39 Stat. 759.

B. EVEN IF THERE COULD BE ANY DOUBT THAT NEITHER THE INCOME TAX PROVISIONS OF THE REVENUE ACTS OF 1916 AND 1917, NOR THE EXCESS PROFITS TAX PROVISIONS OF THE REVENUE ACT OF 1917, IMPOSE A TAX ON ANY PORTION OF THE PROCEEDS OF THE ELDORADO SALE, THAT DOUBT WOULD HAVE TO BE RESOLVED IN FAVOR OF THE ELDORADO COMPANY.

(For Argument, see page 84, *infra.*)

All doubts respecting the scope and meaning of a tax statute are to be resolved in favor of the taxpayer.

Gould v. *Gould*, 245 U. S. 151.

See, also:

Crocker v. *Malley*, 249 U. S. 223, 233.

C. ANY OTHER INTERPRETATION WOULD NECESSITATE THE CONCLUSION THAT CERTAIN PORTIONS OF THESE PROVISIONS OF THE REVENUE ACT OF 1916 WERE UNCONSTITUTIONAL, OR AT LEAST RAISE GRAVE DOUBTS IN THAT REGARD, AND, THEREFORE, CANNOT BE ACCEPTED.

(For Argument, see page 85, *infra*.)

A statute must be so construed, if fairly possible, as not only to avoid the conclusion that it is unconstitutional but even grave doubts upon that score.

U. S. v. *Jin Fuey Moy*, 241 U. S. 394, 401.

U. S. v. *Delaware & Hudson Co.* 213 U. S. 366, 408.

ARGUMENT.

I.

THE WINDING-UP SALE OF ALL THE PROPERTY OF THE ELDORADO COMPANY WAS MERELY A TRANSFORMATION OF CAPITAL, AND NOT A SALE MADE IN THE COURSE OF BUSINESS, AND THEREFORE THE PROCEEDS WERE IN NO PART INCOME WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT, BUT WERE WHOLLY CAPITAL, NOT CONSTITUTIONALLY TAXABLE UNDER THE INCOME TAX PROVISIONS OF THE REVENUE ACTS OF 1916 AND 1917, OR UNDER THE EXCESS PROFITS TAX PROVISIONS OF THE REVENUE ACT OF 1917.

A. THE PROCEEDS OF THE SALE BY THE ELDORADO COMPANY WOULD BE CONSTITUTIONALLY TAXABLE UNDER THE INCOME TAX PROVISIONS OF THE REVENUE ACTS OF 1916 AND 1917, AND THE EXCESS PROFITS TAX PROVISIONS OF THE REVENUE ACT OF 1917, ONLY TO THE EXTENT IF ANY THAT SUCH PROCEEDS WERE INCOME WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT.

This proposition is so self-evident as to require no argument in its support. We will, therefore, do little more than call attention to the statutory and constitutional provisions on which it is based.

The Eldorado sale was made in the year 1917, and the tax statutes applicable to that year, under which the tax payment here sought to be recovered was assessed and its payment enforced, were Title I of the Revenue Act of 1916, as amended by the Revenue Act of 1917, and Titles I and II of the Revenue Act of 1917.

Such of the applicable provisions of these acts as are of importance in this connection are as follows:

REVENUE ACT OF 1916.

Title I, Part II, Section 10, First Paragraph.

(As amended by Sec. 1206 of Revenue Act of 1917.)
(40 Stat. 333.)

"Sec. 10. (a) That there shall be levied, assessed, collected and paid annually upon the total net income received in the preceding calendar year from all sources by every corporation * * * organized in the United States * * * a tax of two per centum upon such income * * *."

Title I, Part I, Section 2 (a).

(As amended by Sec. 1200 of Revenue Act of 1917.)
(40 Stat. 329.)

"Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, *or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property*, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, *or gains or profits and income derived from any source whatever.*"

Title I, Part II, Section 10, Third Paragraph.
(39 Stat. 766.)

"For the purpose of ascertaining the *gain derived or* loss sustained from the sale or other disposition by a corporation * * * of property, real, personal, or mixed, acquired before March first, nineteen hundred and thirteen, the fair market price or value of such property as of March first, nineteen hundred and thirteen, shall be the basis for determining the amount of such *gain derived or* loss sustained."

REVENUE ACT OF 1917.

Title I, Section 4.

(40 Stat. 302.)

"SEC. 4. That in addition to the tax imposed by subdivision (a) of section ten of such Act of September eighth, nineteen hundred and sixteen [the Revenue Act of 1916], as amended by this Act, there shall be levied, assessed, collected, and paid a like tax of four per centum upon the income received in the calendar year nineteen hundred and seventeen * * * by every corporation, * * * subject to the tax imposed by that subdivision of that section * * *.

The tax imposed by this section shall be computed, levied, assessed, collected, and paid upon the same incomes and in the same manner as the tax imposed by subdivision (a) of section ten of such Act of September eighth, nineteen hundred and sixteen [the Revenue Act of 1916], as amended by this Act * * *."

Title II, Section 201.

(40 Stat. 303.)

"SEC. 201. That in addition to the taxes under existing law and under this act there shall be levied, assessed, collected, and paid for each taxable year upon the income of every corporation * * * a tax (hereinafter in this title referred to as the tax) equal to the following percentages of the net income:

Twenty per centum of the amount of the net income in excess of the deduction (determined as hereinafter provided) and not in excess of fifteen per centum of the invested capital for the taxable year;

Twenty-five per centum of the amount of the net income in excess of fifteen per centum and not in excess of twenty per centum of such capital;

Thirty-five per centum of the amount of the net income in excess of twenty per centum and not in excess of twenty-five per centum of such capital;

Forty-five per centum of the amount of the net income in excess of twenty-five per centum and not in excess of thirty-three per centum of such capital; and

Sixty per centum of the amount of the net income in excess of thirty-three per centum of such capital.

For the purpose of this title every corporation * * * not exempt under the provisions of this section shall be deemed to be engaged in business, and all the trades and businesses in which it is engaged shall be treated as a single trade or business, and all its income from whatever source derived shall be deemed to be received from such trade or business.

This title shall apply to all trades or businesses of whatever description, whether continuously carried on or not * * *."

Title II, Section 206.
(40 Stat. 305.)

"Sec. 206. That for the purposes of this title the net income of a corporation shall be ascertained and returned * * * (c) for the taxable year upon the same basis and in the same manner as provided in Title I of the Act entitled 'An Act to increase the revenue, and for other purposes,' approved September eighth, nineteen hundred and sixteen [the Revenue Act of 1916], as amended by this Act * * *."

The tax payment sought to be recovered in this case was made on an alleged "income and excess profits tax," imposed by the Commissioner of Internal Revenue on a portion of the proceeds of the Eldorado sale, which really comprised three alleged taxes—an alleged "income tax" based on the above quoted Section 10 of the Revenue Act of 1916, as amended by the Revenue Act of 1917, an alleged additional "income tax" based on the above quoted Section 4 of the Revenue Act of 1917, and an alleged "excess profits tax" based on the above quoted

Section 201 of the Revenue Act of 1917. The tax imposed by each of these sections, as an examination of the above quoted provisions of the Revenue Acts shows, is a tax on "income"—on income as defined by Section 2 (a), of the Revenue Act of 1916, as amended, and as further defined by the third paragraph of Section 10 of the Revenue Act of 1916—and the Commissioner based his assumed authority to impose these alleged taxes on the ground that certain words (those italicized in the above quotations) in said Sections 2 (a) and said third paragraph of Section 10 served to define such portion of the proceeds of the Eldorado sale as "income" subject to these three taxes.*

The United States Constitution has always contained the following provisions:

Article I, Section 2, Clause 3.

"* * * direct taxes shall be apportioned among the several States which may be included within this Union, according to their respective numbers * * *."

Article I, Section 9, Clause 4.

"No capitation or other direct tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken."

Aside from the effect of the Sixteenth Amendment, which we shall shortly take up and discuss, it is clear that the taxes so sought to be imposed by the Commissioner in this case are subject to these limitations of the Constitution and therefore would have to be apportioned (which they are not) to be constitutional. The case of *Pollock* v. *Farmers' Loan & Trust Co.* 157 U. S. 429, 158 U. S. 601, leaves no

*See proposition III, *infra*, for our argument to the effect that these statutory provisions, properly interpreted, furnish no basis for any tax on the proceeds of the Eldorado sale.

doubt on this point. For, although the income tax law there in question did not include in its definition of income the words, "sales, or dealings in property," relied on by the Commissioner in this case, it is evident that the decision of the court—that a tax on dividends and interest from personal property and on rentals from real property was subject to apportionment—would apply with at least equal if not greater force to the alleged income tax, here in question, on a portion of the proceeds of a winding-up sale of a coal mine and coal-mining plant.

As soon as the decision in the *Pollock* case was handed down, in May, 1895, it was generally recognized that no comprehensive unapportioned income tax was possible without a constitutional amendment.

In 1909, when Congress determined it was necessary to increase the revenue by taxing corporations it concluded that because of the *Pollock* case a corporation income tax was not practicable and it, therefore, avoided the constitutional difficulty by imposing taxation on corporations in an entirely different form—that of an excise tax. That the Corporation Tax Act of 1909 was in no sense an income tax has been repeatedly recognized by this court.

In February, 1913, the Constitution was amended by the addition of the Sixteenth Amendment, which reads as follows:

> "The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

This obviously changed the situation and, in reliance on this amendment, Title I of the Revenue Act of 1916, and Titles I and II of the Revenue Act of 1917 were passed, with the idea that the taxes laid by them were

taxes on income and that as far as such taxes were concerned the Sixteenth Amendment had removed the necessity for apportionment that had existed under the original Constitution. That this was the opinion on which Congress acted is clear. It is equally clear that these unapportioned "income" and "excess profits" taxes can only be sustained as constitutional on the basis of the Sixteenth Amendment—that is, they can be sustained as constitutional only if the property on which they are laid truly constitutes "income" within the meaning of the Sixteenth Amendment. This is especially true of those provisions of these acts in reliance on which the Commissioner assumed to impose a tax in this case on a portion of the proceeds of the Elderado sale. For, even if the unapportioned taxes imposed by these titles, in some applications, might have been constitutional under the original Constitution, it is evident that in this particular application—to the proceeds of a sale—such taxes can be valid only if the property taxed is in fact income within the meaning of the Sixteenth Amendment.

Our contention is, of course, that these provisions, properly interpreted, impose no tax on the proceeds of the Eldorado sale, and we treat this fully under proposition III, *infra*. However, if they do impose any such tax they are clearly unconstitutional.

What would be the effect of declaring unconstitutional any application of these provisions to the Eldorado sale? At the very most the court would have to strike out of the Revenue Act of 1916 the words italicized in the above quotations. This would not weaken or mutilate the act in any way, but would leave it as well rounded as before and even more capable of consistent and equitable administration.

We shall contend that a winding-up sale by a corporation does not, aside from any constitutional question, result in income to the corporation itself. The attempt to tax income to the corporation on account of such a transaction illustrates the length to which the Treasury Department feels that it must go in order to enforce its contention that the sale of a capital investment may result in income. It suggests that the premise upon which the tax in such cases is based is itself open to question. We shall, therefore, consider first the soundness of such premise—that the sale or conversion of a capital investment may produce income—and present the other contentions later.

B. THE PROCEEDS OF THE SALE BY THE ELDORADO COMPANY WERE WHOLLY CAPITAL—IN NO PART INCOME WITHIN THE MEANING OF THE SIXTEENTH AMENDMENT.

1. *There is a fundamental difference between a profit realized on a sale by a merchant or trader in the course of his business and a gain resulting from an increase in a capital investment; income arises on the sale in the case of the merchant, but, in the case of the capital investment, income arises neither on the sale nor prior thereto.*

There is a fundamental difference between a profit realized in money from the buying and selling of goods in the course of the conduct of a trade or business and an increase in the money value of a capital investment. The merchant who engages in the business of buying and selling commodities for profit does not expect to realize his profit primarily from an advance in the value of such commodities after their purchase and before their sale. He cannot expect that the commodities in which he deals will always be going up in value. If he is to remain in business he must expect to have ready for sale at all

times the commodities in which he deals, regardless of fluctuations in their money value. He depends for his profit on his ability to buy in one market and sell in another, or to buy at wholesale and sell at retail, and to continue his operations as a regular course of business so as to realize a profit continuously, regardless of changes in the value of his goods. He does not buy a lot of goods, wait until they increase in money value, and then sell, with the idea of making his profit out of an increase in the money value of his investment. On the contrary, his object in engaging in business is to make a profit on his sales even though values remain the same. A person who expects to make a profit out of fluctuations in the money value of commodities is known as a speculator, not a merchant, and a speculator often expects to make a profit out of a *decrease* as well as an increase in the money value of commodities. Both the merchant and the speculator get their profit and their income out of *their business,* not out of an increase in the money value of property in which they have invested. It is perfectly proper to measure their income in dollars and cents, because they are in the business of making a money income out of buying and selling goods.

Turn, however, to the investor of capital. His object is entirely different from that of the trader. He expects to get his income from interest or dividends paid to him by others who are using his investment in their business, or out of the rent of property used or occupied by others. The income which he thus expects to get is an entirely different matter from an increase in the value of his capital investment. The money return in the form of interest, dividends or rent is his income. An increase in the money value of his investment may not and very often does not represent

any real increment in value. A tax, therefore, upon an increase in the money value of an investment might in fact be a tax upon an actual investment loss. He would be a foolish investor who should think he had realized a profit from an investment which had increased only slightly in money value while all other goods and commodities had increased in money value to a much greater extent. Yet such an investor would be taxed by the government on a money profit which represented an actual investment loss, if the contention of the government in this case were sustained.

This difference in money values and actual values, while of negligible consequence in the case of income from a business, or from interest, dividends or rents, has always been treated as a matter of vital importance in the case of capital investments. Long term leases and contracts have taken fluctuations in money values into account, and have tried to provide for repayment in gold coin of a certain standard, or in some other standard of value not subject to the fluctuations of the usual currency. To treat, therefore, increase in the money value of an investment as income, when the investment is converted into money, is to create income out of something which heretofore has not been regarded as income at all. If the view that such increase in value, when converted into money, becomes income is to be sustained, it can make no difference how long the investment may have remained unconverted, or what changes may in the meantime have taken place in the value of the currency. Income may be created by means of a depreciated currency. On the theory of the government it makes no difference how long after March 1, 1913, a capital investment may be sold; if it has increased in money value since that time the increase will be income in the year of the sale, with-

out regard to actual values and the fact that the sale may represent a real investment loss.

Perhaps no period of time in the history of the country illustrates this point better than the period of the recent war. As compared with the value of money, there was a striking advance in the value of almost all kinds of property. To tax an investor, or an owner of his own home and personal effects, on account of an increase in the money value of such property at such a time, might very probably result in the levy of an income tax on an investment loss instead of gain. A man who was obliged to move from one city to another might sell his first home at an increase in money value and find himself obliged to pay more than he had realized for an inferior home in the other city. In fact, even if these parties merely exchanged their homes, the government would demand from each an income tax based on such transaction, on the theory that the purely nominal increase in money value was a true income.

The income of the merchant is not, as we have seen, based upon an increase in the money value of the property traded in. The claim to tax income in the case of the sale of a capital investment is based entirely upon such increase in money value. Because, in both cases, property may be sold above cost, it is claimed that income is realized in both cases by reason of the sale. The fallacy in such contention will be clearly shown in the course of the argument. It is indicated by the difference, already alluded to, in the objects which the trader and investor have in mind. The merchant or trader realizes his profit only by the sale. Until the sale there is no profit, and whether there is increase or decrease in values before the sale is of no consequence. On the other hand, the increase in the value

of a capital investment realizes the gain to capital just as much before as after a sale or conversion. Capital is continuous, no matter what the form of the investment, and the object of the investor in selling or converting is entirely different from the object of the merchant or trader in making sales.

The decisions of the English courts, which will be cited more at length hereafter, are based upon the distinction above stated between the trader and the investor or owner not in business.

In *Hudson's Bay Co. Ltd.* v. *Stevens*, 5 Tax Cases, 424, Lord Farwell says (p. 437):

> "It is clear, therefore, that a man who sells his land, or pictures, or jewels, is not chargeable with income tax on the purchase-money or on the difference between the amount that he gave and the amount that he received for them. But if instead of dealing with his property as owner he embarks on a trade, in which he uses that property for the purposes of his trade, then he becomes liable to pay, not on the excess of sale prices over purchase prices, but on the annual profits or gains arising from such trade, in ascertaining which those prices will no doubt come into consideration."

In *Assets Company, Ltd.* v. *Forbes*, 3 Tax Cases, 542, Lord Young, referring to the situation of a trader, says (p. 548):

> "The trade is good or bad according as it is carried on profitably or not, in purchasing goods at the trader's price and in selling them at a retail price, or wholesale price, or larger price than that which he paid for them; *and the profit or loss on his business consists in selling them at a profit or not.* But it is another proposition altogether that, where that is not a trade, a gain or loss upon the purchase and resale of property comes within the meaning of the Income Tax Acts. Take even proper traders; if proper traders sell their old premises and buy new ones, and sell the old premises at a higher price than

they paid for them, investing in the purchase of the site and the erection of new premises the prices which they got, I should say it was a totally untenable proposition that anything in excess of what they had paid for the old premises, perhaps 20 years before, *and which they got at a better time, that any excess upon the price which they paid at the better time is income within the meaning of the act. I do not think it is at all.* It is no more so in the case of a trader's income than in the case of a private individual selling his house at more than he had paid for it, or selling his carriage or pictures at more than he had paid for them. That is not income in any sense; while a dealer in pictures, like a dealer in goods or a dealer in the buying and selling of houses, who made it a trade, would then come within the region of income tax."

In this last case the court calls attention to the injustice of an income tax on the selling of a capital investment where the property had been bought "at a better time" twenty years before. The property might be worth considerably more in money than it was when purchased, and yet, based upon real values, it might be worth no more than other investments that might have been made twenty years before. As a capital investment it might not have increased in value at all, when compared with other investments.

That income from an investment means primarily dividends, interest or rents or return of that character, and not increase in value of the investment, whether the investment is sold or not, is illustrated by the decisions of the courts in connection with the rights of life tenant and remaindermen under a trust, which will also be cited more fully hereafter. The question in these cases turns on the meaning of income as used expressly in connection with a capital investment. The life tenant is entitled to income from the investmert delivered to the trustee and the remaindermen to the capital on the death

of the life tenant. Under these circumstances the problem as to what is income from an investment has been directly raised, and the courts hold that income from an investment does not include increase in the value of the investment itself, whether sold and converted or not. The trustee cannot create income merely by selling or exchanging an investment which has increased in money value.

In a case of this kind, *Ex Parte Humbird*, 114 Md. 627, the court says (p. 633):

> "The fact that, as here, the property may have been unproductive of income does not affect the ownership of its augmented value. This consideration might influence its purchase or retention as an investment *but would not change from corpus to income any part of the fund realized from its sale.*"

The court here emphasizes the object in view in the sale and conversion of a capital investment, an object which is entirely different from the object which the trader has in mind in selling property. We shall show that the decisions of this court have made the same distinction between the investor and the trader.

2. *This court has decided that, in the case of a merchant in the course of his business, income accrues and is received when he sells for a profit, but that, in the case of an investor, income does not accrue and is not received while his capital investment is increasing in value, nor when the investment is sold.*

The case of *Gray* v. *Darlington*, 15 Wall. 63, decided that there was a clear legal distinction between the income of a merchant selling, in the course of his business, for a profit, and the increase in the value of an investment which is sold. The income tax provisions of the Internal Revenue Act of March 2, 1867 (14 Stat. 477 *et seq.*),

there in question provided that a tax should be "paid annually upon the gains, profits and income of every person," derived from certain specified sources "or from any other source whatever," and should be paid on such gains, profits and income for the preceding year. The plaintiff had purchased certain bonds in 1865 and sold them in 1869 at an advance of $20,000 in money. It was held that this increase in money value was not taxable as income for the year 1869, in which the bonds were sold. The court said (15 Wall., at p. 65):

> "The advance in the value of property during a series of years can, in no just sense, be considered the gains, profits, or income of any one particular year of the series, although the entire amount of the advance be at one time turned into money by a sale of the property."

Yet this court in the same case also held that, in the case of sales by a merchant and trader in the conduct of his business, his income would depend upon profits realized from sales in the preceding year, even though he purchased the goods sold in some prior year. His annual income was based upon sales for profit within the year in his business as a trader, and not upon increases in the money value of the property sold. The Act of 1867, therefore, taxed what was ordinarily understood to be income which resulted from selling for a profit, but was held not to tax advance in the value of a capital investment in any year, even in the year in which the property was sold, because such advance in value was not income. This court said (15 Wall., at p. 66):

> "The mere fact that property has advanced in value between the date of its acquisition and sale does not authorize the imposition of the tax on the amount of the advance. Mere advance in value in no sense constitutes the gains, profits, or income speci-

fied by the statute. It constitutes and can be treated merely as increase of capital."

It is evident the court did not mean that advance in value was capital only if there was no sale of the property. There had been a sale in that case. If selling at a profit in the case of capital assets is to be likened to the selling for profit of the trader and merchant, then the same rule must apply and the profit must be income in both cases for the year in which the sale is made. *Gray* v. *Darlington* holds the contrary as to the sale of a capital investment. It decides that, even where the capital investment is sold, advance in value is not income at all, but merely increase of capital and not subject to a tax as income. Therefore even the advance in value which accrued during the year of the sale was not taxed as income for that year. All of the advance in value was in fact held to be capital and not income.

This case therefore makes the distinction we have pointed out between selling for profit in the case of a merchant and the selling of a capital investment which has increased in value. If the merchant had bought property in 1865 in the course of his trade, and it had in fact increased in value, and he had sold it in 1869 for a profit, that profit would have been income for the year 1869 and taxable as such under the Act of 1867. But this was held not to be so in the case of the sale in 1869 of a capital investment. The merchant would be taxed, not on the increase in the value of the property, but on the profit on the sale. He might have made a profit if property values remained the same. He was in the business of making income by buying and selling property, and his income was income for the year in which the sale was made. It arose and accrued in that year and was received in that year. His profit would be taxable as

income in the year of the sale under the Act of 1867, and, as we shall show, under the income tax provisions of the Tariff Act of October 3, 1913, also.

The difference between the merchant and the investor is not made to depend upon the wording of the statute (upon whether the words "arising or accruing" or "received" are used) but upon the fact that a sale by one produces income and the sale by the other does not. *Gray* v. *Darlington* decides not only that advance in the value of a capital investment is increase of capital and not income, but also that the sale of the investment does not produce income, as does a sale by a merchant in his business. The result would be the same under a statute taxing income in the year in which it is received, because *income which does not arise or accrue at any time can never be received*, and *Gray* v. *Darlington* holds that increase in the value of an investment does not accrue as income before a sale, because the increase is capital and not income, and also that it does not accrue as income in the year of the sale, as it does in the case of sales by a merchant in the course of his business. The only ground on which such a conclusion can possibly be based is that no income results from such a transaction.

The distinction made in *Gray* v. *Darlington* is in harmony with the decisions of the English courts under their income tax acts, and is in harmony with the decisions in this country made prior to the passage of the Sixteenth Amendment, as we shall show later. *Gray* v. *Darlington* established the law as it must be applied in the construction of the word "incomes" in the Sixteenth Amendment, and this court has since reaffirmed and followed that decision.

In *Lynch* v. *Turrish*, 247 U. S. 221, which arose under the income tax provisions of the Tariff Act of October 3,

1913 (38 Stat. 166 *et seq.*), this court expressly reaffirms the decision in *Gray* v. *Darlington* and the principle upon which the decision is based. In that case the court had under consideration the question of the taxability of the profit derived by a stockholder in a corporation through the sale of the property of the corporation after March 1, 1913, and the distribution of the proceeds to the stockholders in exchange for their stock in connection with the liquidation of the business of the corporation. This court held that the stockholder was not taxable under the Act of 1913 on account of profit derived from the sale of the capital assets represented by his stock.

Here, again, it is clear that if the profit had been realized by a sale after March 1, 1913, by a merchant or trader, the profit would have been subject to a tax as income, even though the property had been purchased in a prior year. *Gray* v. *Darlington* so holds. But a merchant or trader was not involved. The question was as to the profit of a stockholder on his investment merely by reason of the increase in the value of such investment, and the increase had all taken place prior to the effective date of the act, March 1, 1913. It is clear that the sale itself did not transform into income and capital what was before all capital. No income was realized after March 1, 1913, by the sale, or it would have been taxable, as in the case of the merchant, or as in the case of a dividend paid after that date though earned prior thereto. *Lynch* v. *Hornby*, 247 U. S. 339. The decision, therefore, necessarily holds that income in such a case could not be realized by the sale of the investment.

This court points out that if there was any such thing as income in such a case it must have arisen or accrued prior to March 1, 1913, and such income was outside of

the proxisions of the Act of 1913, using the following language (247 U. S. at p. 229):

> "If increase in value of the lands was income, it had its particular time and such time must have been within the time of the law to be subject to the law, that is, it must have been after March 1, 1913. But, according to the fact admitted, there was no increase after that date and therefore no increase subject to the law."

The opinion then goes on to declare, following *Gray* v. *Darlington*, that the advance in value would not in any case be taxable because it is capital and not income, saying (247 U. S., at p. 230):

> "Besides, the contention of the government does not reach the principle of *Gray* v. *Darlington*, which is that the gradual advance in the value of property during a series of years in no just sense can be ascribed to a particular year, not therefore as 'arising or accruing,' to meet the challenge of the words, in the last one of the years, as the government contends, and taxable as income for that year or when turned into cash. Indeed, the case decides that such advance in value is not income at all, but merely increase of capital and not subject to a tax as income."

It is clear, therefore, that no income arises or accrues during the period of the advancement in value of capital. It is clear also that such advance in value does not accrue as income in the year in which the property is sold. *Gray* v. *Darlington* and *Lynch* v. *Turrish* both so hold.

The fact that the Act of 1916 taxes income "received" in the taxable year does not alter the situation, because no income could be received in the year of the sale if no income arose or accrued either in the years in which the advance in value took place or in the year of the sale. It is difficult to see how income could be received which had never at any time arisen or

accrued. If the advance in value was capital until the sale, the sale could not relate back and make such advance arise and accrue as income in the prior years in which it was held to be merely increase of capital.

The language of this court in the still more recent case of *Eisner* v. *Macomber*, 252 U. S. 189, confirms the conclusion that the sale of a capital asset could not create income, even though there were a previous advance in value. Income is defined as "the gain derived from capital" with this statement (252 U. S., at p. 207):

> "Here we have the essential matter: *not* a gain *accruing* to capital, not a *growth* or *increment* of value *in* the investment; but a gain, a profit, something of exchangeable value *proceeding from* the property, *severed from* the capital, however invested or employed, and *coming in*, being '*derived*,' that is, *received* or *drawn by* the recipient (the taxpayer) for his *separate* use, benefit and disposal;—*that* is income derived from property. Nothing else answers the description."

This statement, coupled with the subsequent statement in the opinion (pp. 214-215) that "enrichment through increase in value of capital investment is not income in any proper meaning of the term" must mean that a mere sale of a capital investment that has increased in value cannot suddenly divide the capital into income and capital. That would create income by taking it out of capital; it would not be a severing from the capital but a subtraction from it, contrary to the definition already given.

The further statement, in connection with this definition, that income must "be understood to include profit gained through a sale or conversion of capital assets, to which it was applied in the *Doyle* case," does not in any way enlarge the definition, as we shall show, *infra*, in

tating what was decided by that case—*Doyle* v. *Mitchell Brothers Co.* 247 U. S. 179.

Two things seem to be clearly established by these decisions: first, that the advance in value of a capital investment is capital and not income; second, that the mere conversion of capital into money, even where there has been an increase in capital value, does not produce income.

That these propositions are indeed established law, under the decisions of this court, has just been recognized in the United States District Court for the District of Connecticut, by District Judge Thomas. In deciding the case of *Brewster* v. *Walsh*, on December 16, 1920, he held unconstitutional an attempt, under the Revenue Act of 1916, to tax as income increases of capital value realized in money by sales of investment securities for amounts in excess of their March 1, 1913, value. In other words, that case involved the same constitutional question, under the same statute, as the case at bar, and Judge Thomas decided that question exactly as we are here contending it should be decided, and in reliance on the same cases of this court. *Brewster* v. *Walsh* has not yet been reported but printed copies of the opinion of Judge Thomas will be furnished to this court.

3. *Cases decided by this court under the Corporation Excise Tax Act of* 1909 *are not inconsistent with the decisions of this court previously cited.*

We have already called attention to the fact that this court has held that, "the Corporation Tax Act of 1909 was not intended to be and is not in any proper sense an income tax law," but was "an excise tax upon the conduct of business in a corporate capacity." *Stratton's Independence, Ltd.* v. *Howbert*, 231 U. S. 399, 414; *Flint*

v. *Stone Tracy Co.* 220 U. S. 107. It is necessary to have this point in mind in considering cases decided under that act.

In *Doyle* v. *Mitchell Brothers Co.* 247 U. S. 179, this court stated (p. 183) that the purpose of the Act of 1909

> "was not to tax property as such, or the mere conversion of property, but to tax the conduct of the business of corporations organized for profit by a measure based upon the *gainful returns from their business operations and property from the time the act took effect.*"

The only question involved in the *Doyle* case related to the measure of the tax under the Act of 1909 in the case of profits accruing from the operations of a lumber manufacturing corporation doing business with a wasting capital. The profit in question resulted from the operations of the business; there was no conversion at one time of all the capital assets of the corporation. The distinction between the two things was in the mind of the court, because Mr. Justice Pitney, who wrote the opinion in the *Doyle* case, had already, in *Stratton's Independence* v. *Howbert, supra,* after stating that the Act of 1909 was not an income tax act, said (231 U. S., at p. 414):

> "For this and other obvious reasons we are little aided by a discussion of theoretical distinctions between capital and income. Such refinements can hardly be deemed to have entered into the legislative purpose * * * It is not correct, from either the theoretical or the practical standpoint, to say that a mining corporation is not engaged in business, but is merely occupied in converting its capital assets from one form into another. *The sale outright of a mining property might be fairly described as a mere conversion of the capital from land into money.* But when a company is digging pits, sinking shafts, tunneling, drifting, stoping, drilling, blasting, and hoisting ores, it is employing capital and labor in transmuting a part of the realty into per-

sonalty, and putting it into marketable form. The very process of mining is, in a sense, equivalent in its results to a manufacturing process. And, however the operation shall be described, the transaction is indubitably 'business' within the fair meaning of the Act of 1909; and the gains derived from it are properly and strictly the income from that business; for 'income' may be defined as the gain derived from capital, from labor, or from both combined, and here we have combined operations of capital and labor."

See, also,

Von Baumbach v. *Sargent Land Co.* 242 U. S. 503, 521.

In the *Doyle* case also the court was dealing, not with a conversion of capital assets by an investor, but with profit as the result of a manufacturing operation involving a wasting capital. At the very beginning of the opinion (247 U. S., at p. 181), it says:

"Plaintiff is a lumber manufacturing corporation which operates its own mills, manufactures into lumber therein its own stumpage, sells the lumber in the market, and from these sales and sales of various by-products makes its profits, declares its dividends, and creates its surplus. It sells its stumpage lands, so called, after the timber is cut and removed. Its sole business is as described; it is not a real estate trading corporation."

The plaintiff did not deny that it was subject to a tax each year based upon the profit from its timber operations. The question was as to amount of its profit. It had, as the court says, "made a return for each of the years 1909, 1910, 1911, and 1912, and in each instance deducted from its gross receipts the market value, as of December 31, 1908, of the stumpage cut and converted during the year covered by the tax. *There appears to have been no change in its market value during these years.*"

The Commissioner of Internal Revenue, however, allowed only a deduction of the cost of the timber in 1903, when acquired, and refused to allow the difference between the cost and the fair market value of the timber on December 31, 1908. This difference was the basis for the additional taxes claimed for the years after 1909. This court held the claim of the government was erroneous.

The only question decided, therefore, in the *Doyle* case related to the amount of the taxable profits realized from the conduct of a manufacturing business involving a wasting security. It was possible to hold that all of the proceeds realized in each year from the sale of stumpage were the measure of the profit, as had been held in the case of mining corporations. (*Von Baumbach* v. *Sargent Land Co.* 242 U. S. 503.) The court held that the situation in the two cases was not the same. If a deduction was to be allowed it might have been based on cost, as the government contended. In view of the fact, however, that the Act of 1909 was an excise tax which measured the tax by profits resulting from corporate operations, it was held that the deduction should be based on December 31, 1908, values, so that no profit not the result of corporate activities after the act became effective should be a basis for the tax. Referring to the increase in the value of the timber lands, this court said (247 U. S., at p. 187):

> "Their increased value since purchase, as that value stood on December 31, 1908, was not in any proper sense *the result of the operation and management of the business or property of the corporation while the act was in force.*"

The *Doyle* case, therefore, did not involve any question with reference to income derived by an investor from a conversion of capital. The court, again, as in

Stratton's Independence v. *Howbert, supra,* had the distinction in mind, and said (247 U. S. at p. 187):

> "When the act took effect, plaintiff's timber lands, *with whatever value they then possessed,* were a part of its capital assets, *and a subsequent change of form by conversion into money did not change the essence.*"

Here is an express recognition by the court of both of the points decided in *Gray* v. *Darlington.*

The profit which was the measure of the tax in the *Doyle* case was not a mere increment in value of a capital investment. It was a profit realized from sales in the course of the operation of a business, and if all proceeds from sales had been taxable in the case of such a wasting industry, there would have been no reason for bringing in values as of December 31, 1908. The sale in each case made the profit, and the tax was not based on an increase in the value of capital assets. In the *Doyle* case there was no change in the market value of the stumpage after January 1, 1909, but a tax was nevertheless paid in each year based on the selling price in each year of the timber sold.

Obviously, therefore, the *Doyle* case is in no way inconsistent with *Gray* v. *Darlington* or *Lynch* v. *Turrish, supra.*

The cases of *Hays* v. *Gauley Mountain Coal Co.* 247 U. S. 189, and *United States of America* v. *Cleveland, Cincinnati, Chicago & St. Louis Ry. Co.* 247 U. S. 195, extend the application of the Act of 1909 to cover all gains resulting from corporate activities whether such gains are increases in capital or income. Sales of property by corporations, while the corporations were continuing in business, were held to be transactions which resulted in gains which were made the basis of the tax, provided no increase accruing prior to January 1, 1909,

was included in determining the profit. In other words, if the selling price represented an advance above cost, the portion of such advance, if any, which accrued after January 1, 1909, was held to be an increase arising from corporate activities which was included within the terms of the act. This court stated (*Hays* v. *Gauley Mountain Coal Co.* 247 U. S., at p. 193) that it was "the general purpose of the Act of 1909 to measure the tax by *the increase arising from corporate activities* together with the income from invested property." The distinction between sales for a profit by a merchant or trader, where the income arises on the sale, regardless of changes in value, and increases in the value of capital are therefore disregarded when the statute is an excise tax statute whose purpose is to tax gains accruing to capital, as well as income from it, which result from corporate activities.

It should be noticed, however, that this court is careful to point out in the *Hays* case that the purchase of stock was made for the very purpose of making a profit from the sale of it, and not with the object of deriving income from such property in the usual way. This court says that "the gain represented by the increase of selling price over cost price must be regarded as a substitute for whatever return some other form of investment might have yielded."

In other words, the *Hays* case does not decide that under the Act of 1909 an excise tax can be based upon a gain said to be realized from the mere sale or conversion of a capital investment.

It is obvious that the decision in the *Doyle* case relates to a profit accruing from a sale in the course of the conduct of the corporate business, just as in the case of a sale by a merchant or trader. The tax is not measured by the increase in the value of capital assets. In all

of the cases cited the gains are the result of corporate activities and are therefore within the general purpose of the Act of 1969, whatever this court may now hold to be the true distinction between capital and income.

It should be noticed, also, that corporations engaged in a merchandise business undoubtedly paid a tax measured by their profits from sales made after January 1, 1969, regardless of increases in value of property sold, and even though some of the property so sold had increased in value prior to that date. Of course, as we have pointed out, no income accrued in such cases prior to that date, because in such cases, as was held in *Gray v. Darlington*, the income arises and accrues on and by reason of the sale at a profit. It would have been impossible as a practical matter to apply to a corporation selling merchandise the principle applied in the case of *Hays v. Gauley Mountain Coal Co., supra*, and ascertain the market or fair value of all the merchandise on December 31, 1968, for the purpose of measuring profit from sales, and, if such a principle had been applied, no doubt a great deal of the income arising and accruing from sales after that date would have escaped the tax. A trader could sell at the January 1, 1969, market value, make a profit and pay no tax. The principle of *Hays v. Gauley Mountain Coal Co., supra*, was therefore an exceptional one, even under the Act of 1969.

It is clear, therefore, that no case decided by this court under the Act of 1969 sustains the government's contention that increase in the value of capital—a gain accruing within the period in which the increase in value takes place and not on the sale—is income, or becomes income on a sale of the property when the moment before it was capital. No such question was in fact involved in those cases.

4. *If increase in the value of an investment accrues as income during the period of such increase, it cannot become income only when the investment is sold; and if increase in the value of an investment is capital, and never, even on a sale of the investment, accrues as income, the increase in value can never be received as income.*

Both of these propositions, as we have already shown, are concluded by the decisions of this court. Nevertheless, as the government still contends that such increase in value of capital is or may become income when the property is sold, it is necessary to show clearly the underlying fallacy of such contention.

It is important in this matter that words do not deceive us. The distinction between paying an income tax on an accrual basis and paying it on a receipt basis is intelligible. The income has happened, and the only question is as to the time of the tax. But income must happen; it must have its time. It must accrue in that sense in order to be received or taxed as income.

Increase in the value of property, therefore, if it is not itself income—does not accrue as income—cannot, merely as increase in value, result in or become income. The profit of the trader is not increase in value transformed into income. It is a profit which has its particular time, as well as its amount, independently of any change or increase in the value of the property traded in.

Mr. Justice McKenna touched the heart of the matter when he said in *Lynch* v. *Turrish* (247 U. S., at p. 229):

> *"If increase in value of the lands was income, it had its particular time and such time must have been within the time of the law to be subject to the law, that is, it must have been after March* 1, 1913."

After pointing out this difficulty in the government's contention in that case, on the assumption that increase in value of the lands was income, the court holds that such increase in value is not income at all but capital, and does not become or accrue as income when the property is sold. It would, of course, be a contradiction in terms to say that increase in value of capital accrues as income in the years in which the increase takes place, and yet that such increase only arises and accrues as income when it is realized by a sale. If such increase does accrue as income in the years prior to sale, then of course such increase would be taxable in each of such years under a statute taxing income arising and accruing in each year, as does the Act of 1913 in the case of individuals, and fluctuations in the value of the same property might involve repeated income taxes. No attempt has been made to enforce such a construction of that statute. It may therefore be taken as conceded by the government that increase in value of capital does not accrue as income in the years prior to the sale of the property.

If this is true, then it is obvious that Mr. Justice Pitney in his opinion in *Hays* v. *Gauley Mountain Coal Co., supra,* did not successfully distinguish the case of *Gray* v. *Darlington* on the basis of the difference in the Acts of 1867 and 1909. Mr. Justice Pitney there called attention to the fact that the Act of 1867 taxed gains, profits and income *for* the preceding year, and that the Act of 1909 taxed gains or income *received* during the year, saying (247 U. S., at p. 192):

> "The expression 'income *received during* such year,' employed in the Act of 1909, *looks to the time of realization rather than to the period of accrument,* except as the taking effect of the act on a specified date (January 1, 1909), *excludes income that accrued before that date.*"

But the holding in *Gray* v. *Darlington* was that income not only did not accrue in the year of sale, but did not accrue in any of the years prior thereto, because the increase was capital and not income. If income did not accrue in the year of sale, nor in any prior year, it could not have been *received* in the year of sale, and would not therefore have been taxed even if the Act of 1867 had taxed income *received during* the year. Increment in capital without any accrual of income cannot make income received.

Perhaps it may be argued that when the investment is sold, the difference between cost and selling price then determined is referred or relates back into the prior years and then for the first time becomes income in those prior years. This would not only require the filing of amended returns in the past years, but some rule would be required to determine how the amount of gain actually converted into money should be apportioned in the prior years. If the property had fluctuated considerably in value in the past years this would be a difficult matter to determine. As to this suggestion, perhaps it is enough to say that the government has never attempted to apply it.

In this connection it will be well to refer to a statement in Mr. Justice Pitney's opinion in *Eisner* v. *Macomber, supra*, because it will doubtless be cited by the government in support of its contention. Mr. Justice Pitney there said (252 U. S., at p. 212):

> "It is said that a stockholder may sell the new shares acquired in the stock dividend; and so he may, if he can find a buyer. It is equally true that if he does sell, *and in doing so realizes a profit, such profit, like any other, is income, and so far as it may have arisen since the Sixteenth Amendment* is taxable by Congress without apportionment. The same would be true were he to sell some of his original shares at a profit."

The statement that a profit, if realized on the sale of the stock, would be taxable as income "like any other" profit, might indicate that the tax in such a case would accrue on the sale in the same way as on a sale by a merchant. But this idea is immediately negatived by the following words, "and *so far as it may have arisen since the Sixteenth Amendment is taxable.*" This shows that such tax would *not*, as in the case of the merchant, accrue when the sale is made, regardless of any prior increase in value or of the time of it, but is, somehow, a tax on an increase in the value of capital after the adoption of the Sixteenth Amendment, which never accrued as income at all. The statement is not full enough to make it clear what Mr. Justice Pitney had in mind. We shall state more fully under the next heading why a gain in capital cannot be realized as income by a conversion of capital, and show that increase in capital cannot be turned into income afterwards by such a conversion. We respectfully submit that, in any event, such a profit cannot properly be described as "like any other," because this court has itself held that the profit of the merchant accrues and becomes income in the year of the sale, and does not accrue or relate back into past years.

The tax on stock dividends was, as this court held, a tax on capital. It was in fact a tax on increment in capital, and if the stock dividend and the profit realized on a sale of the stock were both taxed, there might be a double tax on the same increase in capital. A stockholder selling his stock just before the stock dividend was received would pay a tax on the same increase in value upon which the purchaser would pay a tax when he received the stock dividend. In both cases the tax would in fact be a tax on capital. Taxing part of the proceeds on a sale of stock made immediately after the receipt of the stock dividend would be a tax on the same

increase in capital that would have been taxed by taxing the stock dividend.

We refer to the situation of the investor in stocks, not only on account of this dictum in the opinion in the *Macomber* case, but because it illustrates strikingly the inconsistencies that are involved in the attempt to treat increase in capital value as income at any time, either at the time of or prior to the sale of a particular piece of invested capital that has increased in value. The fallacy of the government's contention lies in the fact that increase in capital, as such, whether before or after sale, never becomes income. This fallacy was seen and stated by this court in its opinion in *Gray* v. *Darlington*.

Finally, it may be said that the situation of the investor is just like that of the merchant, that income accrues and is realized only on the sale for profit, that *Gray* v. *Darlington* and *Lynch* v. *Turrish* were wrongly decided, that the question of when the increase in value takes place is of no consequence, and the tax is on the profit on the sale regardless of when the increase in value took place. This is merely an argument that the tax must be sustained in any event, regardless of principle and authority. We cannot believe that this court will overrule *Gray* v. *Darlington* merely for the purpose of extending the meaning of the word "incomes" in the Sixteenth Amendment. Moreover, as we shall show, the fallacy in the contention of the government cannot be cured in that way.

5. *An increase in the money value of capital is not realized as income by a sale or conversion of the capital.*

If a man discovers a valuable gold mine on his property, his capital necessarily increases in value. Is there any justification in such a case for saying that there is no realized gain until he exchanges the gold mine for a

lead mine or converts it into money? Working the mine will, of course, produce income, but it cannot be said that no gain in capital will be realized until the gold mine is sold or exchanged for other property which may not be as safe as an investment.

It seems to be conceded by the government that there is a gain from the discovery of the gold mine and that the gain is an increase in the value of capital. It remains an increase in the value of capital until the moment of conversion into something else, and at that moment the increase in value, represented by the then value of the gold mine in something else, suddenly becomes income. The gold mine is capital as long as it is retained, but the moment it is parted with it is income. The gain is increase in capital before the sale, and the same gain is realized as income the moment after, and is then treated as though it had accrued as income previous to the sale, although it is definitely settled that it did not in fact so accrue as income.

This idea of income as a gain realized by conversion of capital which has increased in value is evidently due to a confusion of ideas in two particulars: *first*, the fact that a merchant or trader realizes income only when he *sells* the property in which he trades suggests the idea that any sale, when increase in value has already occurred, must likewise produce income; *second*, it has been assumed that an accounting practice in recording capital values was based on a distinction between capital and income, when in fact it is not.

(1) The situation of the merchant and trader in selling for profit cannot be likened to the situation of the investor. They are essentially different, as we have shown. It is perfectly proper to refer to a sale for profit by a merchant as realizing income. The sale in such a case

does just that. The sale makes the profit and the income; that is the way the income of a business is made. It is not increase in value, but business ability to sell at a profit that creates income, and it is not realized till the sale is made.

To speak, however, of an increase in a capital investment becoming a realized gain only when the capital has been converted into money or some other kind of property is a misuse of language. We refer in common speech to a man's capital as having increased, regardless of whether he has recently converted it into money or not. Converting it into money does not increase or diminish capital. Keeping the capital in money, or investing it in some other property, does not "change the essence," as this court said in *Doyle* v. *Mitchell Brothers Co., supra.* The careful investor considers income in the proper sense, as well as market values, in making investments. He is not in the business of making a money income from selling his investments for a profit, but if he is prudent he may change his investments from time to time. Does such a change involve a question of income? That has not been the popular understanding. If it does, does an increase in capital become a realized gain only in case capital is converted into money, and can a tax be avoided if conversion is made directly into some other property without employing the medium of money?

In *Eisner* v. *Macomber, supra,* this court says that, without selling his stock, the stockholder receiving a stock dividend would not have the means to pay his tax; that to tax a stock dividend is to tax a capital increase, "because it requires conversion of capital in order to pay the tax." Precisely the same thing would be true if a capital investment which had increased in value were converted directly into some other property without using money to make the ex-

change. A conversion of capital would be required to pay an income tax on such exchange, and therefore such exchange should not be considered as producing income. But can it be that the mere use of money to make such an exchange involves a realized gain which results in income?

In English practice it is common to speak of realizing capital when what is meant is converting it into money and not into other property, but this manner of expression did not mean that income was received through such a capital realization. Capital would be realized in that sense even though no increase in value had taken place. The Commissioner of Internal Revenue, however, refers to the realization of capital which has increased in value as a transaction which results in income, whether capital is converted into money or some other property. He has overruled his first conclusion—that exchanges of capital investments do not produce income—as we shall show later, and has carried his theory to its logical conclusion, even though it involves a claim of income in transactions which no one ever before supposed could be considered as producing income.

In the view of the Commissioner an exchange of one kind of capital investment for another may involve income for one or both parties. For instance, the owners of adjoining timber lands have been in the habit of exchanging tracts with one another in order to consolidate their holdings. If both tracts have increased in value since March 1, 1913, such an exchange will involve an income tax to both parties. (Treas. Dept., Int. Rev., Income Tax Rulings, Bulletin No. 14-20, page 8, O. D. 429.) If a man moves from Chicago to Washington and exchanges his Chicago home for a home in Washington, and both houses have increased in value since March 1, 1913, both parties to the exchange are subject to an income tax.

If a stockholder's stock has increased in value and he exchanges it for stock in another company, he may have an income tax to pay.

In all these cases the theory of a realized capital gain is applied to produce income. Obviously, in all of these cases the capital gain was realized just as much before as after the exchange. The investor still has an investment, the new one may prove poorer than the old, and he must convert capital in such a case to pay an income tax.

Of course a man who is paid a salary in goods must pay an income tax, and a merchant or trader who accepts payment for his goods in other merchandise must also pay a tax if he has made a profit, but he pays a tax because his transaction is not a mere conversion of capital, as it is in the case of the investor, but because the transaction is made for the purpose of realizing a profit in the conduct of a business. The property which he receives in exchange is part income and part capital, and he is not required to convert only capital to pay the tax.

In the case of the investor, on the other hand, the property which has increased in value is conceded to be all capital at the time of the exchange. The increase in value has already accrued, not as income, but as capital. When the exchange is made the property received is all capital, not part capital and part income, as in the case of the merchant. This exchange of properties, therefore, again illustrates the essential difference between conversion of capital by an investor and a sale of goods, whether for cash or commodities, by a merchant. In the one case there is only a capital transaction, in the other income accrues for the first time on the sale.

(2) Accounting practice in regard to values, particularly with reference to corporations, has largely determined the Commissioner's definitions.

The accountant starts with a fixed value for capital. Changes in capital are represented by appreciation or depreciation, which are distinguished from capital so long as the property is not sold or converted. When the property is sold he starts again with a new value for capital, on the theory that appreciation or depreciation has then for the first time been realized. He is not concerned in distinguishing between what is legally capital and income. He is concerned with values, and a gain is a gain, without regard to whether the gain is properly described as income or not, though he does not set up on his books a new value for capital every time there is a fluctuation in its value. He records values with reference to each separate property owned and disposed of, not difference between capital and income.

Undoubtedly it is this accounting practice that is responsible for the suggestion, first made in regulations of the Treasury Department, and first incorporated in the statutes in the Act of 1916, that values as of March 1, 1913, should be the basis for determining gain from the sale of property after that date. All the property in the country was assumed to have a fixed value as capital on that date. If it increased in value and was sold the gain was then realized, because only then did the accountant start again with new values. The statute used the word "gain," and therefore it was assumed such a gain was taxable. Of course, on such a theory questions of ownership might be ignored.

Such a theory obviously ignores the necessity of ascertaining what is properly taxable as income. Capital and income, for the purpose of taxation, must be determined with reference to the person taxed. One person cannot legally be taxed for the income of another. Neither

is it true that every gain is income. Increase in the value of capital is no doubt a gain. If it were income it could be taxed as and when it accrued. If such increase is not income when it arises, it cannot become income after the fact, as we have shown.

The March 1, 1913, theory, therefore, which is obviously based upon accounting practice, cannot make income of what is in fact capital. In the case of the merchant the theory is ignored, anyway, as we have pointed out, because it would be impracticable to apply it. The income of the merchant or trader may indeed in some cases be the exact amount of an increase in the market value of the property sold. This may often be true of a real estate dealer or broker, although they have expenses of business which they can deduct in ascertaining income. In any event, their income accrues, as in the case of any other merchant or trader, when sale is made, and they could have been taxed on the profit then made without any reference to March 1, 1913, values.

The case of *Goodrich* v. *Edwards*, No. 663 on the present docket of this court, will present the question of the right of the government to assess an income tax on an individual by reason of the sale of a capital investment. It will also make clear the March 1, 1913, theory of the Department, because it will show that the Department claims the right to use the market value of stock on March 1, 1913, as the basis for determining income on a sale in 1916, without regard to the fact that the stock was acquired by the individual investor prior to March 1, 1913, at a value above the market value on March 1, 1913. This means that an individual who in fact sells his capital investment at a money loss after March 1, 1913, may yet be required to pay an income tax, if the selling price was above the market value of the investment on March 1, 1913.

It is obviously this same accounting practice that lies at the basis of the government's contention in regard to the words "earned surplus and undivided profits" in connection with the definition of invested capital contained in the excess profits tax provisions of the Revenue Act of 1917 (Title II, Section 207—40 Stat. 306). This question is presented to this court at this term in the case of *La Belle Iron Works* v. *U. S.*, and is alluded to here because it shows the same confusion of ideas on the part of the Commissioner with reference to a realization of capital gain. If our contention in this case is sound the contention of the government must fail in the *La Belle* case as well as in this.

The government contends that the words "earned surplus and undivided profits" do not include an increase in the value of capital assets of the corporation until the assets are sold and the gain realized. In that case the money would be "earned surplus and undivided profits." But if the corporation cannot afford to sell, the increase is not an earned surplus and undivided profit, because *the increase in capital* cannot even *be invested capital* until it has first been realized as income by a sale. The answer to this contention is the same that is made above. A gain in capital is realized as capital just as much before a sale as after, and is certainly "earned surplus and undivided profits" to the corporation before as well as after a sale. If those words include only income, then, if our contention is sound, a conversion of capital into money or other property does not produce income, and any increase in value would not be "earned surplus and undivided profits" any more after the sale than before.

The case of *Merchants Loan & Trust Co.* v. *Smietanka*, argued with this case, which involves a sale by a trustee holding for life tenant and remaindermen, also illus-

trates the lengths to which the government is required to go to sustain its theory. It is easy to imagine other similar problems which will arise if this theory is applied generally. If a man turns his store business, which has increased in value, into a corporation for stock, does he realize income by the transaction? Suppose he turns it over to trustees and receives trust certificates, or turns it into a partnership for a partnership interest? It is necessary to read the regulations of the Department in order fully to realize the possibilities that exist for the development of this theory of a realized gain in capital which produces income on conversion. We venture to say that few people who voted for the Sixteenth Amendment had any idea that an income tax could involve the consequences that are developed in the regulations of the Department in connection with this theory of a realized gain. We respectfully submit that this theory, as thus developed, finds no support in the word "incomes" as used in the Sixteenth Amendment.

6. *Prior to the adoption of the Sixteenth Amendment both English and American courts had definitely decided that the sale of capital investments at an advance over cost did not produce income.*

The question presented in the case at bar, and considered above, was definitely settled by judicial decision in both England and America long prior to the adoption of the Sixteenth Amendment. A mere citation of these decisions should be conclusive on the point. But as the Treasury Department continues to insist upon a tax in such cases, it has seemed advisable to consider the merits of its contention, and show, as above, that the decisions are based upon a sound principle. The English courts had passed upon the matter in cases arising un-

der the English Income Tax Acts. The courts of this country had reached the same conclusion in cases involving the division of property between life tenants and remaindermen, and also in *Gray* v. *Darlington, supra,* in which the question arose under the income tax provisions of the Act of March 2, 1867.

(1) The rule as established in English income tax law is based upon a distinction between a trader and an investor, and is that if a sale at more than cost is made in the course of trade or business the profit is income and taxable, but if a sale of capital investments is made at a price representing an increase in value over cost, the proceeds are capital and not income. As Lord Justice Clerk said (*Californian Copper Syndicate* v. *Harris,* 5 Tax Cases, 159, at page 166):

> "The question to be determined being—Is the sum of gain that has been made a mere enhancement of value by realizing a security, or is it a gain made in an operation of business in carrying out a scheme for profit making?"

The English Income Tax Acts (5 and 6 Vict. Chap. 35, and 16 and 17 Vict. Chap. 34) divide taxable income into five schedules, A, B, C, D and E. Schedules A and B relate to landed property, A referring to landlords and B to tenants. Schedule C includes income from interest, annuities, dividends, etc. Schedule D is the general schedule providing for a tax on income from professions, trades and other occupations and on all other profits and gains not charged by any of the other schedules, its terms being "for and in respect of the annual profits or gains arising or accruing to any person or persons whatever residing in the United Kingdom, from any kind of property whatever," and further "other annual profits and gains not charged by virtue of any of

the other schedules contained in the Act." Schedule E relates to salaries, etc., of public officials.

The leading cases in point are:

Northern Assurance Co. v. *Russell* (1889), 2 Tax Cases 577.

Scottish Investment Trust Co. v. *Forbes* (1897), 3 T. C. 231; 31 Scot. Law Reporter 219.

Assets Co. Ltd. v. *Forbes*, (1897) 3 T. C. 542; 34 Scot. Law Reporter 486.

Californian Copper Syndicate v. *Harris*, (1904) 5 T. C. 159, 166; 6 F. 894.

Hudson's Bay Co. v. *Stevens*, (1909) 5 T. C. 424; 25 T. L. R. 709.

Tebrau Rubber Syndicate, Ltd. v. *Farmer*, (1909) 5 T. C. 658; 47 Scot. Law Reporter, 816.

The rule above stated is followed very carefully and exactly by the courts. A rubber company formed to acquire land, and to carry on a business of planting and developing rubber trees thereon, was held not to receive income upon a sale of its lands at a price above cost. (*Tebrau Rubber Syndicate, Ltd.* v. *Farmer*, *supra*.) A company established by charter and granted large tracts of land in Canada by the Crown was held not to realize income upon a sale of these lands, on the ground that the company did not carry on a trade in buying and selling, but that the sales were merely a disposition of capital assets. (*Hudson's Bay Company* v. *Stevens*, *supra*.)

In the case of *Assets Company, Ltd.* v. *Forbes* (*supra*), the court rendered judgment for the company because the Crown had failed to present sufficient facts to sustain its case, but Lord Young in his opinion in that case clearly and carefully stated the distinction between a sale at a profit by a merchant or trader in the course of

business and a sale of an investment by an owner or even by an ordinary trader.

Following the same rule the court in the case of *Scottish Investment Trust Company* v. *Forbes* (*supra*), held that an investment company which sold certain of its investments at a profit received income, because it was part of the ordinary business of the company to make profits by the purchase and sale of investments, the court pointing out that such transactions are not similar to the case of an individual or an ordinary trader selling his capital investments. Likewise, a company, nominally a copper company, which bought large tracts of land and then sold them, was held to have received income, on the ground that the articles of association, and the fact that the company at no time possessed capital sufficient to mine the property, showed that "the Company was formed in order to acquire certain mineral fields or workings—not to work the same themselves for the benefit of the company, but solely with the view and purpose of reselling the same at a profit," and that, therefore, the profit upon the sale was taxable as income.

These cases show that the fundamental distinction upon which we have based our argument in this case was recognized and established by income tax decisions in England long prior to the adoption of the Sixteenth Amendment.

(2) In America, it was the settled law, long before the Sixteenth Amendment was thought of, that a mere increase in the money value of a capital investment realized by a sale was not income. Cases involving trusts for life tenants and remaindermen have given the courts frequent occasion to apply this rule. When, in such cases, there has been a mere increase in value of trust

property sold by the trustee, as in the case of a sale of bonds or real estate, it has been uniformly held that such increase belongs to the corpus of the estate and is not payable to a life tenant as income.

Re Gerry, 103 N. Y. 445.
Van Vleck v. *Lounsbery*, 34 Hun, 569.
Patterson v. *Vivian*, 122 N. Y. Supp. 347.
Furniss v. *Cruikshank*, 181 N. Y. Supp. 522.
Graham's Estate, 198 Pa. 216.
Neel's Estate, 207 Pa. 446.
Hubley's Estate, 16 Phil. 327.
Outcalt v. *Appleby*, 36 N. J. Eq. 73.
Devenney v. *Devenney*, 74 Ohio St. 96.
Ex parte Humbird, 1[illegible] Md. 627.
Jordan v. *Trust Estate of Jordan*, 111 Maine, 124.
Bank v. *Lee*, 66 S. W. (Ky.), 413.
Coleman v. *Grimes*, 110 S. W. (Ky.), 349.
Bank v. *Mulholland*, 85 So. (Miss.), 111.

These cases necessarily rest upon the propositions, *first*, that a mere increase in the value of a capital asset of the trust is not income but an accretion to, and a part of, the capital, *second*, that a sale by the trustee does not convert such increase into income.

We are certain that this court will not now adopt a principle which will make the rights of life tenant and remainderman depend upon the question of whether the trustee sells or does not sell capital of the trust which has increased in value. If such a principle were adopted, it might well follow that a life tenant could compel a sale by the trustee in such a case.

(3) Furthermore, as we have shown before, this court laid down the rule for which we contend, as to gains derived from a sale of capital investments, in passing

upon the question under the income tax provisions of the Act of March 2, 1867. *Gray* v. *Darlington, supra.*

The decision of the Massachusetts Supreme Court in *Tax Commissioner* v. *Putnam*, 227 Mass. 522, is not relevant for the reason stated by this court, in referring to that case, in its opinion in the *Macomber* case (252 U. S., at p. 217):

> "The Massachusetts court was not under an obligation, like the one which binds us, of applying a constitutional amendment in the light of other constitutional provisions that stand in the way of extending it by construction."

But the opinion in this Massachusetts case in fact sustains the contention which we make in the case at bar. The opinion expressly points out that, prior to the adoption in 1916 of the income tax amendment to the Massachusetts constitution, the distinction between a profit from the sale of a capital investment and the profit of a trader was recognized. The trader's profit was taxed as income and the investor's profit was not taxed. The court says (227 Mass., at p. 527):

> "The gains and profits made as a result of carrying on a business of buying and selling goods had been held to be taxable as income under the tax law long before the adoption of the Forty-fourth Amendment. *Wilcox* v. *County Commissioners*, 103 Mass. 544. It there was recognized that *such income might accrue in part from goods purchased before the period of time for which the income was to be reckoned.*"

The court then decides that, when the amendment to the constitution was adopted, it was not the intention that this distinction between a trader and an investor should be continued, and bases this decision upon the view that it was known in Massachusetts in 1914 and 1915 that federal revenue officers were taxing profits of an investor under the income tax provisions of the Tariff

Act of October 3, 1913, notwithstanding *Gray* v. *Darlington,* to which the court refers, and concludes (p. 528):

> "The relevant fact is that the right to levy such a tax on gains of this kind as an income tax was asserted by the federal authorities and generally acquiesced in by the taxpayer as bearing upon what scope shall be given to the word 'income' contemporaneously used in the Forty-fourth Amendment."

This opinion definitely establishes that at the time of the adoption of the Sixteenth Amendment to the federal Constitution the distinction between the situation of the trader and investor was an established and recognized fact. The basis for giving a construction to the Massachusetts amendment which disregarded such distinction was something which happened after and not before the adoption of the amendment to the federal Constitution. The conclusion must be, therefore, that when the Sixteenth Amendment was adopted settled practice recognized the distinction made in *Gray* v. *Darlington* between the investor and a merchant or trader, and that the profit of the investor as determined by a sale was not income at all.

We shall point out later that the statements of the Massachusetts court as to what the federal revenue officers claimed and what was "acquiesced in by the taxpayer" in 1914 and 1915 are not justified by the facts.

The Massachusetts court recognized that the position of the federal revenue officers to which it refers might not be sustained. Recently Judge Thomas, in the United States District Court for the District of Connecticut, in the case of *Brewster* v. *Walsh,* in an opinion (printed copies of which will be furnished to this court) not yet officially reported, has held that the Revenue Act of 1916 is unconstitutional, in so far as it attempts to tax as income an increase in the value of a

capital investment converted into money by a sale of the investment.

We submit that the rule that increase in the value of capital assets, whether converted into money or not, is not income, but capital, was settled law long prior to the adoption of the Sixteenth Amendment, and that that Amendment must be interpreted in the light of what was settled law at the time of its proposal and adoption.

II.

THE WINDING-UP SALE BY THE ELDORADO COMPANY WAS A CONVERSION OF THE CAPITAL OF ITS STOCKHOLDERS AND DID NOT INVOLVE A REALIZATION OF INCOME TO THE CORPORATION, EVEN IF INCOME CAN EVER ARISE FROM THE CONVERSION OF A CAPITAL INVESTMENT WHICH HAS INCREASED IN VALUE.

A. A WINDING-UP SALE DOES NOT INVOLVE A CONVERSION OF TWO INVESTMENTS, ONE AN INVESTMENT OF THE CORPORATION AND ANOTHER AN INVESTMENT OF THE STOCKHOLDERS.

In considering the question of capital and income in connection with a corporation it is necessary to keep in mind at all times the relation of the corporation to its stockholders. The stockholders and the corporation do not own separate properties. The investment of the stockholders is in the property which the corporation holds for their benefit. The stock has no independent value apart from the properties of the corporation. For some purposes the corporation may be regarded as the owner of the properties, and we may therefore speak of the capital of the corporation; for other purposes the stockholders must be considered as the owners of the same properties and the properties as their capital and not

the capital of the corporation. The essential thing to bear in mind is that there are not two properties and two distinct capital investments, one the investment of the corporation and the other the investment of the stockholders. The Treasury Department has forgotten this in claiming that, no matter what the nature of the transaction, both the corporation and the stockholders may always be taxed on account of the same increase in the value of the same property.

In order to make the contention of the Department clear, we will begin with the formation of a corporation. Mr. Smith, who owns a coal mine, decides to operate it through a corporation. He transfers the property after March 1, 1913, to the newly organized corporation for its stock, receiving substantially all of the stock. The coal mine steadily increases in value during its operation by the corporation. Finally, Mr. Smith decides to give up business. Instead of having the corporation sell the coal mine he sells his stock to Mr. Jones. The Department thereupon makes Mr. Smith pay a tax on the increase in the value of his stock as determined at the time of the sale. (Treasury Dept., Int. Rev. Regulations 33, Revised, par. 60.)*

The coal mine continues to increase in value while Mr. Jones owns its stock. Finally, Mr. Jones decides to give up business, but instead of selling his stock, as Mr. Smith did, he has the corporation sell the coal mine and dissolve. Whereupon the Department tells Mr. Jones that the corporation must pay a tax on the increase in the value of the coal mine since its organization, that is, during the whole time that Mr. Smith and Mr. Jones have

*Though the Treasury Department still holds to these theories under the Revenue Act of 1918, the references here given are all to regulations or rulings issued under the Revenue Acts of 1916 and 1917—the acts under which the assessment in this case was made against the Eldorado Company.

owned its stock. (Regs. 33, Rev., par. 366.) Not only that, but Mr. Jones must then pay a tax on the increase in the value of his stock since he bought it from Mr. Smith, on account of the increase in the value of the coal mine since that date. (Regs. 33, Rev., par. 60.)

In other words, while there is in fact only one capital investment, the Department insists that all the time there are two owners, the corporation and the stockholders, who can be treated as the owners of separate investments, and the increase in value of the one investment results, on its sale, in an income tax to both owners based on the same increase in value of the same investment.

We submit that there is a fallacy in the Department's contention. If it is true that the conversion of a capital investment which has increased in value results in income, there cannot be two owners of the same investment both subject to a tax on account of the increase in value of the one capital investment. Only the real or beneficial owner of the property can be considered the owner of the capital investment for the purpose of realizing income from a conversion of capital. Neither a trustee nor a corporation can ordinarily be regarded as the real owners in connection with the sale of a capital investment. The beneficiaries and the stockholders are the real owners of the investment. The original investment did not cost the trustee or the corporation anything, and there is no real basis for measuring cost and selling price in the case of its sale by a trustee or corporation.

Take the simple case of the coal mine stated above, When Mr. Smith turned the coal mine into the corporation for its stock, the coal mine did not cost the corporation as such anything at all. The coal mine gave value to the stock, not the stock to the coal mine. Apart

from the coal mine the stock was valueless. There is no express provision in the Revenue Act of 1916 as to the basis for determining profit from sales of property acquired *after* March 1, 1913, but presumably it is cost, and the Revenue Act of 1918 so provides. (Sec. 202 (a) (2).) Even if it should be assumed that the Revenue Act of 1916 taxes as income a profit said to be realized from a conversion of a capital investment, nevertheless the sale of the coal mine by the corporation would not furnish any basis for measuring income to the corporation, because the coal mine cost the corporation nothing. It did cost Mr. Smith something, and in order to determine profit to him it would be necessary to compare his cost prior to the organization of the corporation with the selling price of his stock.

The Department, however, takes the view that when Mr. Smith exchanged his coal mine for stock in the new corporation, there was a conversion of his capital investment which would subject him to an income tax, provided the coal mine was then worth more than it cost him, or worth more than it was worth March 1, 1913. By exchanging the coal mine for stock that was worth the then value of the coal mine, he was converting his capital and realizing a gain, which was income. So the corporation was paying out its stock, worth the then value of the coal mine, for the coal mine, and the then value of the stock, so determined, was cost to the corporation and furnished the basis for determining income realized by the corporation when the corporation sold the coal mine after it had again increased in value. In this way the one coal mine purchased by Mr. Smith becomes a capital investment for two, Mr. Smith and the corporation. Mr. Smith can sell his investment and realize income based on the value of his stock (the coal mine)

when he acquired it, even though the corporation keeps the coal mine; and the corporation may sell the coal mine and realize income based also on the value of the stock (the coal mine), which it paid for the coal mine, even though Mr. Smith keeps his stock and the corporation buys another coal mine and continues in business. And if the corporation winds up, on making a winding-up sale the corporation pays an income tax on the increase in the value of the coal mine, and Mr. Smith pays an income tax on the increase in the value of his stock, although the coal mine was the only property that had real value and that gave value to the stock. (Treasury Dept., Int. Rev. Regulations 33, Revised, pars. 60 and 366.)

The results arrived at by the Department, we submit, are clearly unsound. If the theory of realized income from the conversion of capital assets necessarily involves such conclusions, then the fault is in the theory itself.

Suppose Mr. Smith, in the case put, had turned the coal mine over to trustees, instead of a corporation, to operate, with directions to pay the income to himself for life and on his death to his son, but with the further provision that in case the coal mine was sold the trust should terminate and the proceeds be paid to him if then living. And suppose the trustees did sell the coal mine in the lifetime of Mr. Smith and paid the proceeds to him. Obviously, in such a case there would be no claim that there were two investments. If any income was realized from the sale, it must be determined on the basis of the cost of the mine to Mr. Smith before the trust was created. There was no cost to the trustees. Mr. Smith, therefore, if anyone, must pay a tax in such a case on any income said to be realized from the sale.

In order to complete the analogy between the situation

of stockholders and their corporation and beneficiaries and trustees, let us compare a winding-up sale by a corporation with a sale by trustees at the end of a life estate in order to distribute the capital of the trust estate amongst remaindermen. If the trustee sells the property at an advance in value, the trustee would not be considered a taxable person even by the Department, because he would retain no income, if it were realized, but would pay it over to the remaindermen, and only the beneficiaries would pay any tax. The situation of the corporation in making a winding-up sale is just the same. It is acting directly as a trustee for the stockholders in making such a sale, and there is no more reason for considering that the corporate trustee has realized income by such a sale than for considering a testamentary trustee to have realized income in the case put.

Whatever the rule may be, therefore, where the corporation itself buys and sells property during its conduct of the business, there can be no question that on a winding-up sale it is the investment of the stockholders, not the investment of the corporation, that is being converted. The situation is again the same that it was when the corporation was organized. The stock and the property are again identified as a single investment and the investment is the investment of the stockholders, the equitable owners of the property. The stock itself is surrendered and disappears as property having any value whatever, and the stockholders come into the possession of the property previously used by the corporation in the conduct of the business.

Obviously the situation is the same that it would be if the property of the corporation had been distributed in kind to the stockholders, and the stockholders themselves had sold it. In that case they would be selling

their own investment and the corporation would sell nothing, but the final result would be just the same.

The Department recognizes this, but, instead of concluding that only one capital investment is sold in such a case, it insists again that there are two investments which are sold, and that for the corporation to distribute the property in kind to the stockholders and for the stockholders thereupon to sell it themselves is a mere evasion which will be disregarded. The Department will therefore consider, contrary to the fact, that the corporation sold the property, and will tax the corporation upon the income which it is claimed it would have realized if it had made a sale,* and will then tax the stockholders also upon the same increase in the value of the same capital investment. This illustrates again the length to which the Department must go in order to sustain its theory. The theory is followed to its logical conclusion regardless of the facts, just as it is in the case of the formation of the corporation.

We shall show that the authorities do not sustain the Department's contention that, in the case of a winding-up sale, the capital investment which is converted is an investment which must be considered as belonging both to the corporation and its stockholders, so that both of them may be subjected to an income tax on account of income claimed to be realized from the conversion of the investment. The decisions of this court will be found to sustain the comment of Lord Johnston in the English case of *Tebrau Rubber Syndicate, Ltd.* v. *Farmer, supra,* when, in referring to a winding-up sale, he said:

> "I have a difficulty in seeing how a company that is wound up can be assessed on income tax."

*Treasury Dept., Int. Rev., Income Tax Rulings, Bulletin No. 19-20 page 20, S. 1385.

B. THE AUTHORITIES SUSTAIN THE CONTENTION THAT ON A WINDING-UP SALE BY A CORPORATION THE INVESTMENT SOLD IS THE INVESTMENT OF THE STOCKHOLDERS, AND THAT ANY PRIOR INCREASE IN THE VALUE OF THE PROPERTY SOLD WAS AN INCREASE IN THE VALUE OF THEIR INVESTMENT.

In *Lynch* v. *Turrish*, *supra*, it appears that the timber lands owned by the corporation there in question had largely increased in value prior to March 1, 1913. At that time all of the stockholders gave an option to sell their stock at twice its par value. The transaction was finally carried through in the same year by a sale by the corporation of all its assets, the purchaser paying therefor an amount sufficient to enable the stockholders to receive twice the par value of their stock, and Turrish, one of the stockholders, did receive such an amount. It was claimed that Turrish was subject to a tax on half of the amount received by him on the ground that it was income. No claim against the corporation itself appears to have been made on account of the increase in the value of the lands.

In dealing with the claim made against Turrish this court bases its decision on the ground (247 U. S. at p. 228) that it had already been held by this court in prior cases "that the investments of the corporation were the investments of the stockholders," citing *The Collector* v. *Hubbard*, 12 Wall. 1, and *Bailey* v. *Railroad Company*, 22 Wall. 604, 635, 636. The stock was not considered by itself as the investment of the stockholders, but the property held by the corporation was in fact regarded as their investment, and the increase in the value of the timber lands was an increase in the value of their capital investment, and was held to accrue as such at the time when the increase in value took

place, prior to March 1, 1913, and before the sale of the property by the corporation.

So it is evident that this court does agree with the view of the English judges, as expressed in the above quotation from *Tebrau Rubber Syndicate, Ltd.* v. *Farmer*, *supra*.

In dealing, therefore, with the situation which arose upon a winding-up sale by the corporation and a distribution of the proceeds to the stockholders, this court ignored any question of a double investment,—the corporation's investment in the property and the stockholders' investment in their stock—and regarded the lands themselves as the investment of the stockholders.

When the question arises, therefore, upon a winding-up sale, which means that the corporation is through with its activities, there is only one investment to deal with, and that is the investment of the stockholders. Income to the corporation has ceased, because the sale of all its assets puts an end to the business of the corporation, and it was only out of that business that the corporation could make an income which was distinct from the income of the stockholders.

Hays v. *Gauley Mountain Coal Co.*, *supra*, decided under the Act of 1909, is of course not inconsistent with this decision. There, as previously pointed out, the corporation bought and sold the property in question during the continuance of its corporate activities, and the tax was an excise tax based upon the gains resulting to the corporation itself from the exercise of such corporate activities.

We respectfully submit, therefore, that there can be no question in this court that the conversion of all the assets of a corporation by a winding-up sale is a con-

version of the investment of the stockholders, and that the corporation cannot be held to receive income on account of such a sale.

III.

NEITHER THE INCOME TAX PROVISIONS OF THE REVENUE ACTS OF 1916 AND 1917, NOR THE EXCESS PROFITS TAX PROVISIONS OF THE REVENUE ACT OF 1917, IMPOSE ANY TAX ON ANY PORTION OF THE PROCEEDS OF THE ELDORADO WINDING-UP SALE—A MERE TRANSFORMATION OF CAPITAL ASSETS.

A. THIS COURT HAS ALREADY HELD THAT THE INCOME TAX PROVISIONS OF NEITHER THE ACT OF MARCH 2, 1867, NOR THE ACT OF OCTOBER 3, 1913, IMPOSED ANY TAX ON A REALIZED INCREASE IN THE VALUE OF CAPITAL ASSETS, AND THE REVENUE ACTS OF 1916 AND 1917 MUST RECEIVE THE SAME INTERPRETATION.

1. *The income tax provisions of neither the Act of March 2, 1867, nor the Act of October 3, 1913, imposed any tax on a realized increase in the value of capital assets.*

The first income tax enacted after the adoption of the Sixteenth Amendment, that imposed by the Act of October 3, 1913, was no broader than that imposed by the Act of March 2, 1867, so far as the claim to tax individuals on a profit said to be realized from the conversion of a capital investment is concerned. The construction, therefore, given by this court to the Act of 1867 must control as to the meaning of the Act of 1913 also.

The Act of 1867 had already been given a construction by this court in *Gray* v. *Darlington*, *supra*, which excluded a tax on the conversion of a capital investment which had increased in value. That the decision in that

case applied to the language of the Act of 1913 was afterwards decided by this court in *Lynch* v. *Turrish, supra.*

In the Act of 1867 the tax was to be paid on income "derived" from specified sources or any source whatever, and was to be paid on income "for" the preceding year. In the Act of 1913 the tax was also on income "derived" from specified sources or from any source whatever, and the tax was to be paid on the net income "arising or accruing" in the preceding year. The net income arising and accruing to domestic corporations was to be ascertained by making certain deductions from the gross income "received" within the year. This court has accordingly held that in the case of domestic corporations the words "arising and accruing" and "received" mean the same thing. *Maryland Casualty Co.* v. *U. S.* 251 U. S. 342.

The use of the word "received" in connection with domestic corporations can make no difference between the situation of individuals and corporations under the Act of 1913, so far as the question involved in this case is concerned. We have already pointed out that, while this court in *Hays* v. *Gauley Mountain Coal Co., supra,* suggested that the case of *Gray* v. *Darlington* might *not* apply when the word "received" was used in the statute, as it was in the Act of 1909, the case of *Gray* v. *Darlington* in fact decided that no income would accrue even in the year in which a capital investment was sold. If income in such a case did not accrue in the year of sale, or in any prior year, as the court there held, then necessarily it could not be "received" in the year of sale, because there was no income to be received. So far, therefore, as the claim that income may be realized from a sale of a capital investment is concerned, individuals and corporations stand alike under the Act of 1913. The decision in *Gray* v. *Darling-*

ton applies to both, and the Act of 1913 cannot be held to tax any such alleged gain as income.

Under the Act of 1913, therefore, the merchant or trader would be taxed on all income arising or received after March 1, 1913. The question of increase at any time in the value of the property sold, whether before or after March 1, 1913, would be irrelevant. The income in such a case would arise or accrue and be received when the sale at a profit was made after March 1, 1913, regardless of whether the property had increased or decreased in value. This is the way in which the Department enforced the statute in the case of a merchant or trader. Whether in such a case the purchaser made a good or a bad bargain did not affect the question of income to the seller.

On the other hand, there is nothing in the Act of 1913 to suggest that a rule different from the rule of *Gray* v. *Darlington* is to apply to a sale of a capital investment. *Lynch* v. *Turrish, supra,* decides that the same rule does apply, and that no income is realized under the Act of 1913 by the sale of a capital investment which has increased in value.

2. *The provisions of the Revenue Acts of* 1916 *and* 1917 *which define the property on which the income and excess profits taxes are imposed are substantially the same as the corresponding provisions of the Act of March* 2, 1867, *and of the Act of October* 3, 1913.

The provisions of interest here of these acts are as follows:

INTERNAL REVENUE ACT OF MARCH 2, 1867.

Section 13, *Second Paragraph.*

(14 Stat. 478.)

That there shall be levied, collected, and paid annually upon the gains, profits, and income of

every person residing in the United States, or of any citizen of the United States residing abroad, whether derived from any kind of property, rents, interest, dividends, or salaries, or from any profession, trade, employment, or vocation, carried on in the United States, or elsewhere, or from any other source whatever, a tax of five per centum on the amount so derived over one thousand dollars, and a like tax shall be levied, collected, and paid annually upon the gains, profits, and income of every business, trade, or profession carried on in the United States by persons residing without the United States, and not citizens thereof. And the tax herein provided for shall be assessed, collected, and paid upon the gains, profits, and income for the year ending the thirty-first day of December next preceding the time for levying, collecting, and paying said tax.

TARIFF ACT OF OCTOBER 3, 1913.

Section II, B.

(38 Stat. 167.)

B. That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent:

REVENUE ACT OF 1916.

Title I, Part I, Section 2 (a).

(As amended by Sec. 1200 of Revenue Act of 1917.)
(40 Stat. 329.)

"Sec. 2. (a) That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income, derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever."

As it appears from the above provisions, the Act of 1916 uses the same language as the Act of 1913 in defining income, except as to dividends. The word "received" is used, instead of the words "arising and accruing," in referring to the income taxed, but that word had already been used in connection with domestic corporations in the Act of 1913 and must receive the same construction as in that act. We shall show later that there are no additional provisions in the Act of 1916 which change the meaning of the words, already construed, which define income.

The Revenue Act of 1917 (as we have already shown under proposition IA, *supra*) adopts by reference the above quoted definition of income contained in the Revenue Act of 1916, as amended.

Furthermore, the language of the excess profits tax provisions of the Revenue Act of 1917, so far as the income of corporations is concerned, applies only to in-

come in the course of the trade or business of a corporation. There is no language in the act which is appropriate to tax an alleged profit on a winding-up sale, which is necessarily not a part of the conduct of its trade or business.

3. *It is, of course, well settled that provisions of a statute which are substantially the same as provisions of a prior statute covering the same subject should be given the same construction as those prior provisions, especially where those provisions had been judicially construed.*

The Abbotsford, 98 U. S. 440, 444.
McDonald v. *Hovey,* 110 U. S. 619, 628.
Sessions v. *Romadka,* 145 U. S. 29, 42.
White-Smith Music Publishing Co. v. *Apollo Company,* 209 U. S. 1, 14.

4. *No rulings of the Treasury Department can affect the duty of the court to give the same interpretation, in this respect, to the Revenue Acts of* 1916 *and* 1917 *as to the Act of March* 2, 1867, *and the Act of October* 3, 1913.

It may be suggested that since the passage of the Act of 1913 the Treasury Department has been developing a theory in regard to the meaning of income, and that therefore the same language used in the Act of 1916 means something different from what it meant in the Act of 1913, because Congress must be assumed to have adopted the Department's theory. Such suggestion is necessarily opposed to the rule of judicial construction above referred to.

But even if this settled rule of construction were disregarded, it would be difficult to tell from the regulations of the Department just what its

theory on this question was in 1916. The Department started, in 1913, with book entries, not realized gains, as the determining factor in ascertaining income in the case of corporations.[1] This start was borrowed from the regulations under the Act of 1909.[2] Apart from these regulations as to book entries, the question of the realization of a gain in capital was first referred to in August, 1914, and then only in a letter to collectors in connection with losses sustained in trade, and it was stated that appreciation in such cases is not income until converted into cash or its equivalent.[3] This ruling reflected corporation accounting practice in connection with the book entry rule, and was in no sense an attempt to state a rule with reference to income claimed to be realized from sale of a capital investment. In December, 1914, this ruling was extended to cover sales of real estate,[4] and in the same month there was a letter with reference to a gain realized by a beneficiary under a will from a sale of securities.[5] In April, 1915, the Department ruled in a letter that an exchange of stock in A Company for stock in B Company did not result in taxable income.[6]

There was no general ruling prior to the passage of the Revenue Act of 1916 to suggest the broad claims and contentions now made by the Department under that statute. There is no suggestion, for instance, of the claim now made in this case with reference to the relation of stockholders and

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[1]Treasury Dept., Int. Rev. Regulations 33, Arts. 107-111.

[2]Treasury Dept., Int. Rev. Regulations 31, Art. II.

[3]Treasury Dept., Int. Rev. Mim. letter of Aug 14, 1914—Published in Corp. Trust Co.'s Income Tax Service 1913-1914, page 295.

[4]16 Treasury Decisions, Internal Revenue, pages 272-273—T. D. 2090.

[5]Letter of Dec. 3, 1914, from Com. of Int. Rev. to collector at New York—Corp. Tr. Co. I. T. Serv., 1913-1914, p. 344.

[6]Letter of Apr. 1, 1915, from Com. of Int. Rev. to W. N. Akers of Corp. Tr. Co.—Corp. Tr. Co. I. T. Serv. 1915, p. 462.

corporations and the double tax on a winding-up sale. Exchanges of properties were evidently not considered as realizing income. Indeed, nothing could better emphasize the fact that the whole theory about a realized gain from a sale or conversion of a capital investment is a theory developed after and not before the passage of the Act of 1916 than a reading of the Treasury Department regulations themselves. The regulations issued prior to the passage of the Act of 1916 do not serve, therefore, as a basis for giving a construction to the definition of income in that act which is different from the same definition in the Act of 1913.

5. *Neither the new provisions of the Revenue Act of* 1916 *making the March* 1, 1913, *value the basis for computing gain or loss "from the sale or other disposition" of property, nor the new provision in that act with regard to losses of individuals, serve to make the scope of the Revenue Acts of* 1916 *and* 1917 *any broader, as to realized increases in the value of capital assets, than the Act of March* 2, 1867, *or the Act of October* 3, 1913.

(1) The general provision[1] in the Act of 1916, and the specific provision[2] in regard to corporations, providing that gains derived from the sale or other disposition of property acquired before March 1, 1913, shall be ascertained by using as a basis the fair market price or value of such property on that date, does not in any way affect the definition of income contained in the act. There is no language in these provisions to indicate that they were intended to apply to the sale or conversion of a capital investment. In the absence of such language, the provisions cannot be construed as referring to transactions already excluded by judicial construction from the definition of income.

[1]Title I, Part I, Section 2 (c), of Revenue Act of 1916—39 Stat. 758.
[2]Title I, Part II, Section 10, third paragraph, of Revenue Act of 1916—39 Stat. 766.

We have already pointed out that there can be no profit to a corporation or trustee from the sale of property by them which has in fact cost them nothing. There is no language in the Act of 1916 which makes provision for measuring profit in such cases. The provision as to values on March 1, 1913, does not cure this difficulty. Certainly there is no provision whatever which suggests that a corporation and its stockholders can both be taxed on account of income said to result from a winding-up sale and dissolution of the corporation. If the profit from the sale of capital investments is to be taxed in all cases, the statute fails to contain provisions absolutely necessary to determine how the tax shall be levied.

The provisions of the act regarding values on March 1, 1913, not only cannot be construed as applying to sales or conversions of capital assets, but they do necessarily include sales in the course of a trade or business which result in income. This is shown by the fact that the section of the act referring to losses in a trade or business, in the case of an individual,[2] contains the same provision as to March 1, 1913, values. Full meaning can, therefore, be given to these March 1, 1913, provisions without including within the definition of income gains said to be realized from sales of capital investments, and settled rules of construction referred to above require that such gains be held not to be income.

(2) It is also evident that the additional provision in the Act of 1916 with reference to losses of individuals, not in the 1913 act, does not indicate an intention to enlarge the definition of income to include gains said to be realized from the sale of a capital investment, which,

[2]Title I, Part I, Section 5 (a) Fourth, of Revenue Act of 1916—39 Stat. 759.

as we have shown, had been excluded from this definition in 1913. In the case of individuals losses are allowed to be deducted when incurred in the taxpayer's own trade or business—"*his* trade or business." Then follows this provision (Section 5 (a), Fifth—39 Stat. 759):

> "*Fifth.* In transactions entered into for profit but not connected with his business or trade, the losses actually sustained therein during the year to an amount not exceeding the profits arising therefrom;"

How inadequate this provision is to enlarge the definition of income is obvious from the language itself. To do that the provision should have covered *every* transaction in which property was sold at an advance in value or at a profit. The provision not only does not do this, but the losses referred to are not specifically losses arising from sales of property of any kind. What the provision recognizes is that income may be received by an individual apart from "his business or trade," and losses are therefore allowed to be deducted in such cases, but such cases would not be isolated transactions, but transactions of a continuous character which would involve both gains and losses. The intention of Congress obviously was to allow losses in all cases where there was taxable income. But the Department claims that income may arise on the sale of every capital investment, even where no losses of any kind could possibly occur to offset advance in value of capital. The words of this provision, "transactions entered into for profit," necessarily exclude the investor, who is primarily concerned with an investment and the income which that investment yields in the ordinary course. In other words, the language suggests, and in fact presupposes, the very distinction we have insisted upon with reference to the meaning of income. There may be income in the usual and recognized

meaning of that word from transactions, businesses, enterprises, and undertakings of various kinds which are not properly described as the taxpayer's own business or trade.

B. EVEN IF THERE COULD BE ANY DOUBT THAT NEITHER THE INCOME TAX PROVISIONS OF THE REVENUE ACTS OF 1916 AND 1917, NOR THE EXCESS PROFITS TAX PROVISIONS OF THE REVENUE ACT OF 1917, IMPOSE A TAX ON ANY PORTION OF THE PROCEEDS OF THE ELDORADO SALE, THAT DOUBT WOULD HAVE TO BE RESOLVED IN FAVOR OF THE ELDORADO COMPANY.

All doubts respecting the scope and meaning of a tax statute are to be resolved in favor of the taxpayer.

Gould v. *Gould*, 245 U. S. 151.

See also:

Crocker v. *Malley*, 249 U. S. 223, 233.

When it is realized what the theory of the Department involves—the determination of values whenever there is an exchange of properties, double taxation in the case of corporations and stockholders, delay in the dissolution of corporations while values on March 1, 1913, and other dates are investigated, the delay and possible prevention of legitimate business transactions—very definite language in a statute should be required to overcome this rule of construction and give to the act the construction which the Department claims. No business transaction of any consequence can be undertaken to-day without considering whether the tax demanded, under this theory of the Department regarding gains realized from the sale or conversion of capital assets, may not be prohibitive. If the theory is sound, definite statutory provisions are required to give it practical operation. Certainly there is no language in the Act of 1916 which can be given a construction which will sustain the contention of the Treasury Department.

C. ANY OTHER INTERPRETATION WOULD NECESSITATE THE CONCLUSION THAT CERTAIN PORTIONS OF THESE PROVISIONS OF THE REVENUE ACT OF 1916 WERE UNCONSTITUTIONAL, OR AT LEAST RAISE GRAVE DOUBTS IN THAT REGARD, AND, THEREFORE, CANNOT BE ACCEPTED.

A statute must be so construed, if fairly possible, as not only to avoid the conclusion that it is unconstitutional but even grave doubts upon that score.

U. S. v. *Jin Fuey Moy*, 241 U. S. 394, 401.

U. S. v. *Delaware & Hudson Co.* 213 U. S. 366, 408.

We have already shown most clearly under proposition I, *supra*, that to give to those provisions of the Revenue Act of 1916 which we italicized in our quotations appearing under that proposition, the scope that the Treasury Department claims for them would render those provisions unconstitutional. The court therefore must give to these provisions the other, the constitutional, interpretation, which is, in view of all the circumstances, the obvious one.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1920.

No. 609.

ELDORADO COAL AND MINING COMPANY,
Plaintiff-in-Error.

vs.

HARRY W. MAGER, COLLECTOR OF INTERNAL REVENUE FOR THE FIRST DISTRICT OF ILLINOIS,
Defendant-in-Error.

IN ERROR TO THE DISTRICT COURT OF THE UNITED STATES FOR THE NORTHERN DISTRICT OF ILLINOIS, EASTERN DIVISION.

REPLY BRIEF FOR PLAINTIFF IN ERROR.

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Press of Byron S. Adams, Washington, D. C.